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Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues

By Roger C. Cramton*

INTRODUCTION

For more than fifty years, numerous and massive corporate frauds (e.g., National Student Marketing in the 1970s,¹ OPM in the early 1980s,² Lincoln Savings & Loan during the S & L crisis of the 1980s,³ and the huge BCCI bank failure and fraud of the 1990s⁴) have raised questions concerning a lawyer's

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1. The spectacular rise and fall of National Student Marketing Corp. led to charges that lawyers in two elite firms (New York's White & Case and Chicago's Lord, Bissell & Brook) had aided and abetted the fraud. Both settled with investors and two accountants were convicted. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978); see GEOFFREY C. HAZARD, JR., SUSAN P. KONIAK & ROGER C. CRAMTON, THE LAW AND ETHICS OF LAWYERING 104–22, 739–43 (3d ed. 1999) [hereinafter HAZARD, KONIAK & CRAMTON] (reprinting and discussing *National Student Marketing* and discussing subsequent SEC proceedings against lawyers who learned that their client's agents violated securities laws); see also *United States v. Natelli*, 553 F.2d 5 (2d Cir. 1977) (reversing the conviction of one of the two accountants).

2. See HAZARD, KONIAK & CRAMTON, *supra* note 1, at 304–10. OPM, the largest commercial fraud at its time, was the most discussed legal ethics case of the 1980s. Fraud claims against banks, accounting firms, and lawyers were subsequently settled for \$65 million, of which Singer Hutner's share was \$10 million. *Id.* at 308; *In re O.P.M. Leasing Servs., Inc.*, 13 B.R. 64 (Bankr. S.D.N.Y. 1981), *aff'd*, 670 F.2d 383 (2d Cir. 1982); see also Stuart Taylor, Jr., *Ethics and the Law: A Case History*, N.Y. TIMES MAG., Jan. 9, 1983, at 31 (presenting a detailed exposé of the involvement of OPM's lawyers in seeing to it that their client's fraud went undiscovered until after the total collapse of the pyramid scheme).

3. Jones Day, which resigned from a regulatory compliance representation of Lincoln Savings & Loan, later settled fraud and other claims of investors for \$24 million and government claims against it for \$51 million. See HAZARD, KONIAK & CRAMTON, *supra* note 1, at 743–56. Kaye Scholer, which succeeded Jones Day, later settled the government's claim against it for \$41 million. *Id.* at 757. For discussion of the savings and loan cases, see William H. Simon, *The Kaye Scholer Affair: The Lawyer's Duty of Candor and the Bar's Temptations of Evasion and Apology*, 23 LAW & SOC. INQUIRY 243 (1998); Symposium: *The Attorney-Client Relationship in a Regulated Society*, 35 S. TEX. L. REV. 571 (1994); *In the Matter of Kaye, Scholer, Fierman, Hays & Handler: A Symposium on Government Regulation, Lawyer's Ethics, and the Rule of Law*, 66 S. CAL. L. REV. 977 (1993).

4. See, e.g., DOUGLAS FRANTZ & DAVID MCKEAN, FRIENDS IN HIGH PLACES 285–400 (1995) (discussing Clark Clifford's role in the BCCI failure); JONATHAN BEATY & S. C. GWYNNE, THE OUTLAW BANK: A WILD RIDE INTO THE SECRET HEART OF BCCI (1993).

responsibilities when the lawyer learns, or has reason to know, that officers or other agents of the lawyer's corporate client are engaged in conduct that violates the law or their fiduciary duty to the corporation and is likely to result in harm to the corporation, shareholders or other third parties. In each of these situations, and in hundreds of less-publicized frauds, outside law firms settled civil liability actions for substantial and sometimes huge sums, while denying that they had assisted or participated in the fraud. Similar lawsuits have already been brought against two law firms involved in the Enron affair, Vinson & Elkins ("V&E") and Kirkland & Ellis ("K&E")⁵ and others are likely to follow.

The Enron affair and the flood of other recent corporate scandals (e.g., Adelphia, Arthur Andersen [hereinafter "Andersen"], Dynegy, Global Crossing, Tyco, WorldCom, Xerox) have led to a loss of investor and public confidence in the integrity of the securities and other markets that make American capitalism work. Investors have lost confidence in the reliability and honesty of corporate executives. Andersen's indictment and conviction for obstruction of justice highlighted the role of accountants in structuring and auditing corporate transactions that turned out to be fraudulent or illegal. But compliant lawyers as well as greedy executives, lazy directors and malleable accountants are necessary for large corporate frauds to come to life and persist long enough to cause major harm.⁶ The assistance of inside and outside lawyers is required to structure and report on corporate transactions. Other reforms will not suffice unless lawyers who violate legal and ethical rules are held accountable.

The premises of this Article are well stated in the recent preliminary report of the American Bar Association (ABA) Task Force on Corporate Responsibility: Even if most corporate officers, directors and professional advisers act honestly and in good faith, the interests of corporate managers are not fully aligned with those of shareholders.⁷ As the Preliminary Report states,

[E]xecutive officers and other employees of public companies may succumb to the temptation to serve personal interests in maximizing their own wealth or control at the expense of long-term corporate well-being. . . . [I]ndependent participants in the corporate governance process, such as the outside directors, outside auditors, and outside counsel [are essential to check such temptation]. *[E]videnced by recent failures of corporate responsibility, the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short. Unless the governance system is changed in ways designed to encourage*

5. Amended Complaint, *Newby v. Enron Corp.*, No. H-01-3624 (S.D. Tex. filed Apr. 8, 2002).

6. See Susan P. Koniak, *Who Gave Lawyers a Pass? We Haven't Blamed the Real Culprits in Corporate Scandals*, *FORBES MAG.*, Aug. 12, 2002, at 58 ("The dirty secret of the mess is that without lawyers few scandals would exist, and fewer still would last long enough to cause any real harm.").

7. ABA Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 *BUS. LAW.* 189 (2002) [hereinafter *ABA Preliminary Report*]; see also Joan C. Rogers & Rachel McTague, *SEC Must Issue Attorney Conduct Rules Under New Federal Accounting Reform Law*, 18 *LAW. MANUAL ON PROF. CONDUCT (ABA/BNA)* 457-58 (July 31, 2002) (reporting and summarizing section 307 of the Sarbanes-Oxley Act).

such active and informed stewardship, . . . public trust and investor confidence in the corporate governance system will not be restored.⁸

Part I of this Article examines the current legal and ethical rules that govern lawyers in client-fraud situations. Part I concludes that these rules are controverted, often ambiguous and provide insufficient guidance to lawyers and inadequate protection to the public interest in preventing corporate frauds and illegalities.

Part II illustrates the theses of Part I by applying the current rules to three problems that regularly arise when managers breach their fiduciary duties to the corporation or embark on fraudulent conduct: (1) advising a corporate client concerning retention of documents and other relevant evidence when it becomes clear that litigation is likely or impending; (2) conducting an internal investigation of allegations that one or more corporate managers have engaged in misconduct; and (3) providing legal assistance in creating, documenting, and reporting client transactions that raise substantial legal problems (primarily securities fraud issues). The complexity and difficulty of these recurring problems are revealed by examining the known facts concerning (1) the advice given Andersen by its inside lawyers, (2) the conduct of V&E's "preliminary investigation" of Sherron Watkins' allegations of misconduct by some Enron managers, and (3) V&E's role in creating and reporting the corporate transactions that appear to be fraudulent and led to Enron's demise.

Part III argues that the problems we now face are systemic in character and not merely a problem of a few executives, auditors, and lawyers who are "bad apples." The inadequacy of the current rules governing lawyers requires that existing rules be clarified and some new ones created. The federal legislation that has already occurred, with its provision for a Securities and Exchange Commission (SEC) rule requiring lawyers to report illegalities to superior officers and the corporate board, is a sound beginning,⁹ but more is required, especially the overruling of the *Central Bank* decision eliminating any claim against professional advisers for aiding and abetting a securities fraud.¹⁰ In addition, state high courts should modify their ethics rules along the lines recommended in the ABA Task Force Preliminary Report.¹¹

ANALYSIS OF THE FACTUAL AND LEGAL ISSUES

What is or should be the role of the corporate lawyer, inside or outside the client corporation, when faced with a client fraud situation? What ethics and liability rules should govern the situation?

8. ABA Preliminary Report, *supra* note 7, at 193–94 (emphasis in original).

9. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784. See discussion in text beginning *infra* note 144.

10. Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994). See discussion *infra* notes 44 and 121–23 and accompanying text.

11. See *infra* notes 157–68 and accompanying text.

The problems are complex ones that turn on factual and legal issues including the following: (1) When and what did the lawyer know at the time of action or non-action?; (2) What scienter (intent) standard should be applied to the lawyer's conduct?; (3) Does a lawyer who learns of facts or circumstances suggesting possible fraud have a duty to inquire further?; (4) When the lawyer knows, or has reason to know, that officers of his corporate client are pursuing a fraudulent course of conduct, should or must the lawyer take this information to the client's highest authority, the board of directors?; and (5) If the officers and the board refuse to cease or rectify what the lawyer believes is fraudulent conduct, may or must the lawyer disclose this information to defrauded third parties or a public officer?

FINDING OR ASSUMING THE RELEVANT FACTS

The initial problems are primarily factual in character.

First, what was the lawyer retained to do by the corporate client (including agreed-upon limits on the scope of representation) and what did the lawyer do? Are the limitations so severe that the lawyer is unable to provide the competent and adequate representation required by ethics rules?¹²

Second, what did the corporate agents do, a purely factual question, and did their actions constitute a breach of fiduciary duty to the organization, a crime or intentional tort that might be imputed to the corporation, or a fraud or other illegality harming third persons (investors, shareholders, creditors, etc.)?

Third, what did the lawyer know, or have reason to know, at the time the lawyer acted or failed to act? The lawyer's conduct should not be judged on the basis of facts learned at a later time. After the dust has settled, and with the benefit of hindsight, it is easier to conclude that corporate managers were engaged in fraudulent conduct that was harmful to third persons and the corporate client. But a judgment based on later-discovered facts is unfair and unlawful.

In representing clients in the vicinity of fraudulent or suspected fraudulent activity, lawyers should bear in mind several fundamental cautions.

First, an innocent state of mind will not save a lawyer from responsibility or liability. Because lawyers convince themselves that they do not "know" that fraud is going on, often ignoring what is plain to see, they believe they are safe from liability. They will not, however, be judged by their recollection of their state of mind. The fact finders who will judge lawyers cannot read their minds and are likely to be skeptical about what the lawyers say they believed and thought. Lawyers will be judged by the facts and circumstances, known or which they had reason to know at the time, that surrounded their actions and what they did in response to those facts and circumstances.

12. A lawyer owes every client a duty of "competent representation," a requirement that can never be waived by the client. MODEL RULES OF PROF'L CONDUCT R. 1.1 (2002). Although Rule 1.2(c) of the Model Rules of Professional Conduct permits a lawyer to "limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent[.]" the client may not be asked to agree to representation so limited in scope as to violate Rule 1.1. *Id.* R. 1.2 cmt. 7.

Second, one of the grave risks professional advisers face is the "hindsight bias": the tendency of all human beings to exaggerate the extent to which an event that they know has happened could have been anticipated in advance.¹³ Any subsequent fact-finding of whether a lawyer knew of and assisted a client's fraudulent conduct almost always arises after bankruptcy or other events have revealed that a fraud occurred. While a lawyer should not be held to have known at the time of action or inaction facts that only became known later, those facts will inevitably color a fact-finder's retrospective judgment. The hindsight bias, in the civil fraud context, makes defendants appear more culpable than they may be. Lawyers, knowing that this will happen, should exercise greater caution than they often do when dealing with a client that is pushing the law to its limits and perhaps beyond. Liability problems always start with clients whose managers are not trustworthy or who create a corporate culture in which short-term goals are the only goals. Caution in selecting and retaining such clients is essential, as well as healthy skepticism concerning their actions and motives.

Third, lawyers cannot rely on the attorney-client privilege to protect them. The privilege belongs to the entity client, not the lawyer. Major frauds that become publicly known usually result in bankruptcy or change in control of the client corporation. The trustee in bankruptcy or other successor in interest typically waives the attorney-client privilege and the professional duty of confidentiality. Every law firm document or communication relating to the representation becomes available to the corporation in a malpractice action against the law firm and to plaintiffs' lawyers in third-party liability actions. Even if the privilege is not waived, other doctrines usually lead to many or most documents becoming available. For example, under the crime-fraud exception to the privilege, a prima facie showing of client fraud penetrates the privilege;¹⁴ under the *Garner* doctrine, a shareholder plaintiff in a derivative suit may obtain otherwise privileged material relating to a plausible derivative claim.¹⁵

A complete factual story of lawyer conduct in the Enron affair is not available as of November 2002 when this Article was completed and may never be fully available. Consequently, my discussion of ethical and legal issues must be based on assumed facts. I will operate on a factual assumption, not yet established but clearly plausible, that Andrew Fastow and perhaps other managers of Enron were engaged in a course of conduct that was fraudulent and perhaps criminal: using unlawful means to make Enron's financial position appear much better than in

13. See Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998) (stating that the hindsight bias is one of the best-established findings of cognitive psychology and examining its implications on fact-finders' decisions). A lawyer's "level of care will be reviewed by a judge or jury who already knows that it proved inadequate to avoid the plaintiff's injury. . . . The bias, in general, makes defendants appear more culpable than they really are." *Id.* at 572 (footnotes omitted).

14. See HAZARD, KONIAK & CRAMTON, *supra* note 1, at 244-54. As Justice Cardozo said, "[t]he privilege takes flight if the relation is abused. A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law." *Clark v. United States*, 289 U.S. 1, 15 (1933); see also Geoffrey C. Hazard, Jr., *An Historical Perspective on the Attorney-Client Privilege*, 66 CAL. L. REV. 1061, 1063-64 (1978).

15. *Garner v. Wolfinbarger*, 430 F.2d 1093, 1103-04 (5th Cir. 1970).

fact it was, while violating their fiduciary duty to Enron by misappropriating for themselves huge sums of money from self-dealing transactions. This factual assumption is supported by the report of Enron's special board investigative committee headed by William Powers,¹⁶ the guilty plea of Michael Kopper,¹⁷ and the first interim report of the examiner appointed by Enron's bankruptcy court.¹⁸

I also assume for purposes of this Article that certain publicly available facts are true: first, the admissions concerning document destruction made by Andersen officials in congressional testimony and, as to his personal conduct, Duncan's guilty plea; second, the facts concerning V&E's representation of Enron included in the Powers Report¹⁹ and, in connection with V&E's "preliminary investigation" of Enron, the facts stated in V&E's opinion letter to Enron of October 15, 2001,²⁰ and the firm's narrative summaries of interviews conducted.²¹

WHAT SCIENTER (INTENT) STANDARD SHOULD BE APPLIED TO THE LAWYER'S CONDUCT?

Should the lawyer's conduct be judged by an "actual knowledge" standard or by the "recklessness" and "willful blindness" standards that are generally applicable to lay persons? This raises the question of why lawyers, who are supposedly experienced and knowledgeable about corporate transactions and the elements of illegality and fraud, should be afforded a less demanding scienter standard in professional discipline cases and SEC aiding and abetting proceedings than the standard that lay persons must meet to avoid criminal and civil liability.

16. See WILLIAM C. POWERS, JR. ET AL., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002) [hereinafter POWERS REPORT], available at 2002 WL 198018.

17. On August 21, 2002, Kopper pled guilty to money laundering and wire fraud charges. His plea agreement described a criminal conspiracy running from 1997 through July 2001, in which Kopper, Fastow, and unnamed others used a series of Enron-related partnerships to conceal debt, falsify Enron's financial position, and make millions for the conspirators at Enron's expense. See Jonathan Weil et al., *Guilty Plea by Enron's Kopper Increases Scrutiny of Ex-CFO*, WALL ST. J., Aug. 22, 2002, at A1.

18. *In re Enron Corp.*, First Interim Report of Neal Batson, Court-Appointed Examiner, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Sept. 21, 2002) [hereinafter BOSTON], available at 2002 WL 31113331. In the report, the examiner analyzes six series of Enron transactions involving special purpose entities (SPEs) selected for their representative character. In each of the transactions Enron purported to sell an asset to an SPE in exchange for cash provided almost entirely by a financial institution. In four of the six transactions Enron or its affiliate entered into a "total return swap" under which Enron was obligated to repay the investment plus a specified return on it. The transactions were supported by Enron's credit because the assets were difficult to sell and produced insufficient cash flow to support the financing. Enron retained control of the assets and the benefit or loss of their rise or fall in value. The examiner's interim conclusions were that: (1) although documented as sales and usually supported by "true sale opinions" provided by Enron's outside lawyers, the transactions were in fact loans, (2) Enron's obligations under the total return swaps were not properly disclosed in Enron's 2000 financial statements as required by GAAP, and (3) the transactions and their reporting "had dramatic effects on both the balance sheet and income statement portions of Enron's financial statements." *Id.* at *7-8.

19. See POWERS REPORT, *supra* note 16, at *15.

20. Opinion Letter from Max Hendrick III, Vinson & Elkins, L.L.P., to James V. Derrick, Jr., Executive Vice President and General Counsel, Enron Corp. (Oct. 15, 2001) [hereinafter Hendrick Opinion Letter], available at 2001 WL 1764266.

21. These interview summaries may be found at the Web site of the House Committee on Energy and Commerce [hereinafter V&E Interview Narratives], at <http://energycommerce.house.gov>.

The profession's ethics rules, designed for purposes of professional discipline, adopt an "actual knowledge" standard. Rule 1.2(d) of the American Bar Association's Model Rules of Professional Conduct,²² dealing with prohibited assistance, states that the lawyer "shall not counsel a client to engage, or assist a client, in conduct that the lawyer *knows* is criminal or fraudulent"²³ "Knows" is defined in the terminology section as "actual knowledge of the fact in question[.]" but adds that "[a] person's knowledge may be inferred from circumstances."²⁴ "Fraud" is defined as "conduct . . . [having] a purpose to deceive" and not merely negligent misrepresentation or failure to apprise another of relevant information.²⁵ These definitions provide greater protection to lawyers in discipline proceedings than other law provides them in other contexts. The definitions create a risk of misleading lawyers concerning the standards by which they will be judged in client fraud situations.²⁶

Federal and state laws dealing with fraud and various deceptive practices generally adopt or are interpreted as embodying a less demanding standard of knowledge of culpable conduct than that of the ABA Model Rules: a lawyer cannot state facts with reckless disregard of their truth or falsity; nor can the lawyer turn a blind eye to facts and circumstances that indicate fraud or illegality—conduct that falls within the "willful blindness" rubric.

Scienter under the federal securities acts may be summarized as follows:

(1) *Criminal liability.* The defendant must be proven to have acted "willfully," that is, with a culpable state of mind.²⁷ The defendant's knowledge of false statements, however, may be inferred "from the actor's special situation and continuity of conduct"²⁸ and "the cumulation of instances, each explicable only by extreme credulity or professional inexperience, may have a probative force immensely greater than any one of them alone."²⁹ The court in *United States v. Benjamin* stated, "the Government can meet its burden [in a securities fraud prosecution] by proving that a defendant deliberately closed his eyes to facts he had a duty to see or

22. The Model Rules of Professional Conduct, first adopted by the ABA in 1983, with subsequent amendments, provide the framework for the legal ethics rules of forty-three U.S. jurisdictions. The rules have also been influential in the eight states that base their rules on the 1969 ABA Model Code of Professional Responsibility. The Model Rules were substantially amended in February 2002, but the many changes have little effect on the issues discussed in this Article. For the amended rules, see the ABA Center for Professional Responsibility Web site, at http://www.abanet.org/cpr/mrpc/mrpc_toc.html (last visited Oct. 17, 2002).

23. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002) (emphasis added).

24. *Id.* R. 1.0(f).

25. *Id.* R. 1.0(d).

26. The ABA *Preliminary Report*, *supra* note 7, at 207, recognizes that the Model Rules' restriction to a lawyer's "knowing" conduct "presumably does not reach conduct covered by the term 'reasonably should know.'" The Report recommends revision of Rules 1.2(d), 1.13, and 4.1 "to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud." *Id.* at 214. These changes, if adopted, would conform the Rules' definition of fraudulent intent to federal and state law governing the subject.

27. *United States v. Benjamin*, 328 F.2d 854, 861 (2d Cir. 1964) (affirming the criminal convictions of an accountant and a lawyer for securities and mail fraud).

28. *Id.* (quoting *Bentel v. United States*, 13 F.2d 327, 329 (2d Cir. 1926)).

29. *Id.* at 862 (quoting *United States v. White*, 124 F.2d 181, 185 (2d Cir. 1941)).

recklessly stated as facts things of which he was ignorant."³⁰ As Judge Friendly put it:

In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. Of course, Congress did not mean that any mistake of law or misstatement of fact should subject an attorney or an accountant to criminal liability simply because more skillful practitioners would not have made them. But Congress equally could not have intended that men holding themselves out as members of these ancient professions should be able to escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen or have represented a knowledge they knew they did not possess.³¹

(2) *Civil liability under securities acts.* In *Ernst & Ernst v. Hochfelder*,³² the Supreme Court found that "[e]ach of the provisions of the 1934 Act that expressly create civil liability [including § 10(b)] . . . contains a state-of-mind condition requiring something more than negligence."³³ The required scienter includes a mental state embracing "intent to deceive, manipulate, or defraud"³⁴ and may be shown by "knowing or intentional misconduct."³⁵ The *Hochfelder* case was extended in *Santa Fe Industries v. Green*³⁶ and *Cort v. Ash*,³⁷ which held that state law governs questions involving the fairness of transactions or internal corporate mismanagement "except where federal law expressly requires certain responsibilities of directors with respect to stockholders"³⁸ Thus allegations of breach of fiduciary duty alone will not suffice; fraudulent or deceptive conduct must be alleged.

Hochfelder and *Aaron* left open the question whether allegations of "recklessness" satisfy the scienter requirement. The federal courts of appeals, however, have almost uniformly concluded that the recklessness and "willful blindness" sufficient for criminal liability also suffice for civil liability. Under the most common standard, recklessness means conduct that is "highly unreasonable" and that represents "an extreme departure from the standards of ordinary care . . . [to the

30. *Id.* at 862 (summarizing the holding of two prior decisions) (citations omitted).

31. *Id.* at 863.

32. 425 U.S. 185 (1976).

33. *Id.* at 209 n.28. In *Aaron v. SEC*, 446 U.S. 680, 691 (1980), in which the SEC sought injunctive relief for a securities violation, the Court held that "scienter is an element of a violation of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought."

34. *Hochfelder*, 425 U.S. at 193.

35. *Id.* at 197.

36. 430 U.S. 462, 473 (1977) (stating that a shareholder's claim under section 10(b) that his shares were undervalued in a merger transaction, but not alleging a misrepresentation, was insufficient because the statutory language and legislative history gave "no indication that Congress meant to prohibit any conduct not involving manipulation or deception").

37. 422 U.S. 66 (1975).

38. *Id.* at 84 (emphasis added).

extent that the] danger . . . [was] either known to the defendant or [was] so obvious that the [defendant] must have been aware of it.”³⁹

The Private Securities Litigation Reform Act of 1995 (“1995 Act”) imposes special pleading requirements on civil plaintiffs in securities fraud actions.⁴⁰ The complaint must “specify each statement alleged to have been misleading,” provide “reasons why the statement is misleading,” and “state with particularity all facts on which [a belief that a statement is misleading] is formed.”⁴¹ Concerning proof of the required state of mind, the complaint must, with respect to each act or omission, “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”⁴²

(3) *Assisting a client’s crime or fraud.* A lawyer’s duty under criminal and civil law to refrain from “assisting” (aiding or abetting) a client in conduct that is “criminal” or “fraudulent” is violated if:

- (1) The client is engaged in a course of conduct that violates the criminal law or is an intentional violation of a civil obligation, other than failure to perform a contract or failure to sustain a good faith claim to property;
- (2) The lawyer has knowledge of the facts sufficient to reasonably discern that the client’s course of conduct is such a violation; and
- (3) The lawyer facilitates the client’s course of conduct either by giving advice that encourages the client to pursue the conduct or indicates how to reduce the risks of detection, or by performing an act that substantially furthers the course of conduct.⁴³

The effect of the holding in *Central Bank of Denver v. First Interstate Bank of Denver*,⁴⁴ eliminating private causes of action for aiding and abetting federal securities laws violations, is to force private plaintiffs to charge defendants as primary violators (principals) rather than secondary ones. In some situations, an alternative course of action is to proceed under state securities or fraud laws that permit aiding and abetting claims.⁴⁵

39. *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc decision frequently cited in other circuits). Decisions in a few circuits support an arguably more relaxed standard of something more than negligence. See, e.g., *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 n.98 (2d Cir. 1973) (en banc) (finding that reckless conduct exists if the defendant, knowing that material facts were omitted or misstated, failed to obtain and disclose such facts when doing so could be done without extraordinary effort); see generally Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV. 667 (1991).

40. Pub. L. No. 104-67, § 21D(b), 109 Stat. 737 (codified as amended at 15 U.S.C. §§ 77-78 and 18 U.S.C. § 1964).

41. § 21D(b)(1)(B), 109 Stat. at 747.

42. § 21D(b)(2), 109 Stat. at 747.

43. Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Legally Wrongful Conduct?*, 35 U. MIAMI L. REV. 669, 682-83 (1981).

44. 511 U.S. 164 (1994). The *Central Bank* case is discussed *infra* at notes 121-23 and accompanying text.

45. A plaintiff’s resort to state securities laws must take account of the Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227, which “preempted state statutory and common law securities fraud claims by requiring class actions involving nationally traded securities to be brought exclusively in federal court under uniform federal standards.” Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1295-96 (1999).

(4) *SEC aiding and abetting actions against professional advisers.* The 1995 Act authorizes the SEC to bring actions for injunctions and monetary penalties against any person, including a professional adviser, who “knowingly provides substantial assistance to another person in violation” of federal securities laws.⁴⁶ The statute substitutes an actual knowledge standard for the “recklessness” standard that governs civil liability of primary offenders under section 10(b) and criminal liability of all actors for aiding and abetting.⁴⁷

A DUTY OF INQUIRY?

When the lawyer learns facts that, if true, strongly suggest that a corporate officer has engaged in illegal or fraudulent conduct, what should or must the lawyer do? Probably the most unsettled and controverted question is whether a lawyer must investigate suspicious circumstances that suggest fraud or follow up on specific allegations of fraud. There is very little direct precedent. A few federal cases hold that inquiry is required under some circumstances:

The O'Melveny case. In *FDIC v. O'Melveny & Myers*,⁴⁸ the receiver of a failed thrift was held to have stated a claim for relief against a law firm that had assisted the thrift in two real estate syndications offered to investors. When the private placement was made, the thrift was in unsound financial condition; its officers had fraudulently overvalued assets, embezzled funds, and generally “cooked the books.” The complaint alleged that O'Melveny, knowing of the recent resignations of the thrift's prior auditors and outside law firm, did not question the auditors, the law firm, federal or state regulators, or the thrift's financial officer about the thrift's financial status before giving legal opinions and doing other work that assisted the thrift in soliciting investors. After the thrift failed, the Federal Deposit Insurance Corporation (FDIC), acting as conservator, rescinded the investments and was assigned the investors' claims against O'Melveny. The receiver then brought suit against O'Melveny for professional negligence (malpractice) and negligent misrepresentation (third-party liability). The U.S. Court of Appeals for the Ninth Circuit, reversing the trial court's dismissal of the complaint, held that these allegations stated claims for relief.⁴⁹ *O'Melveny* holds that the recent resignations of the issuer's prior auditor and lawyer were suspicious circumstances, known to the lawyer, that required further inquiry.⁵⁰ The duty of due care owed to both the investors and the client required a “reasonable, independent investigation” of the

46. 15 U.S.C. § 78t(e) (2000).

47. See *supra* note 42 and accompanying text.

48. 969 F.2d 744 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *reaffirmed on remand*, 61 F.3d 17 (9th Cir. 1995). The Supreme Court based its reversal on a concern that the initial decision was grounded on a federal common law ruling that the FDIC was not bound by certain equitable defenses that could have been raised by the bank, *O'Melveny & Meyers*, 969 F.2d at 752; on remand, the U.S. Court of Appeals for the Ninth Circuit held that its initial decision was based, as it should have been, on California and not federal law, *O'Melveny & Meyers*, 512 U.S. at 89.

49. *O'Melveny & Meyers*, 969 F.2d at 752.

50. *Id.* at 749.

client's financial status before giving legal opinions and assisting the client in soliciting investors.⁵¹

The Clark case. In *FDIC v. Clark*,⁵² the receiver of a failed bank sued the bank's outside counsel for failing to investigate claims made in a civil lawsuit against the bank that alleged that the bank's president had conspired to defraud the bank of several million dollars through a fraudulent loan scheme. The lawyers accepted the president's explanation of the situation and failed to inquire further or to inform the board of directors of the allegations. The court upheld a jury verdict against the lawyers, stating that "there was ample proof for the jury to find that defendants were negligent in their professional duties to the bank, and that their negligence was a cause of loss" to the bank.⁵³

The Schatz case. Some decisions, however, take a "no duty" approach in the third-party liability context as distinct from the malpractice context. *Schatz v. Rosenberg*⁵⁴ is the most vivid and notorious example of a case holding that a lawyer has no duty to correct client misrepresentations to third persons before closing a transaction with the defrauded person.⁵⁵ The plaintiffs alleged that the lawyer, aware that the client's financial situation had deteriorated, forwarded the client's false financial statement to the person buying the client's business and taking in return an unsecured note for a portion of the purchase price. When the client filed for bankruptcy, the purchasers suffered financial loss. The court affirmed dismissal of counts charging the firm with liability as an aider and abettor under federal securities law and Maryland tort law. The court held, agreeing with the U.S. Court of Appeals for the Seventh Circuit, that "lawyers have no duty to disclose information about clients to third party purchasers or investors in the absence of a confidential relationship between the attorney and the third party."⁵⁶ When the lawyer merely documents the transaction and does not himself make representations to the third party or provide a legal opinion that does so, the lawyer is not liable even though ordinary agency law (applicable to agents of sellers generally) would impose liability.⁵⁷ *Schatz* and other cases apply a lower standard of conduct to lawyers negotiating and preparing documents for a client transaction than would be applied to a used-car salesman acting for his principal.

Some ethics opinions discuss situations in which a lawyer must either make further inquiry or decline to provide an opinion or service. The ABA Preliminary Report states that a lawyer who uncritically accepts management's instructions and limits advice or services to a narrowly defined scope, "ignoring the context

51. *Id.* (quoting *Felts v. Nat'l Account Sys. Ass'n*, 469 F. Supp. 54, 67 (N.D. Miss. 1978)).

52. 978 F.2d 1541 (10th Cir. 1992).

53. *Id.* at 1551.

54. 943 F.2d 485 (4th Cir. 1991).

55. *Id.* at 492.

56. *Id.* at 490 (footnote omitted).

57. See RESTATEMENT (SECOND) OF AGENCY § 348 (1958). "An agent who fraudulently makes representations, . . . or knowingly assists in the commission of tortious fraud . . . by his principal . . . is subject to liability in tort to the injured person although the fraud . . . occurs in a transaction on behalf of the principal." *Id.*

or implications of the advice they are giving[,]" may violate obligations owed to the corporate client and the public.⁵⁸ The Report also states: "The ABA has long advised that lawyers providing transactional opinions that may be relied upon by third parties cannot blindly accept facts posited by the client; they must question and investigate the factual predicate for their advice, at least to some extent and in some circumstances."⁵⁹

CLIMBING THE CORPORATE LADDER

If a lawyer learns, or has reason to know, of prospective or ongoing fraud on the part of the corporation's managers and they refuse to cease or rectify their course of conduct, should the lawyer take the problem to the corporation's highest authority, usually the board of directors? Is "loyal disclosure," that is, disclosure of client confidences within the client entity, different than disclosure outside the organization (e.g., whistleblowing to the SEC, persons thought to be harmed, or the press)?

Model Rule 1.13(b), addressing the situation in which an organization's lawyer "knows" that an agent is engaged in conduct in violation of fiduciary duties to the organization or in law violations harmful to the organization, states that a lawyer "shall proceed as is reasonably necessary in the best interest of the organization."⁶⁰ Although the Rule does not explicitly require an organization's lawyer to take a problem up the corporate ladder, that response, I believe, is required in

58. *ABA Preliminary Report*, *supra* note 7, at 207 (citing and quoting from ABA ethics opinions directed at lawyers who provide tax opinions "on hypothetical facts in circumstances in which the opinions served to facilitate fraudulent transactions"). E.g., ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346, 68 A.B.A. J. 471 (1982).

59. *ABA Preliminary Report*, *supra* note 7, at 208 n.49. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 335 (1974) (quoted in ABA Formal Op. No. 346, *supra* note 58, at 472) explains the lawyer's duty to investigate:

[T]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect, or are suspect, or are inconsistent, or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. The extent of this inquiry will depend in each case upon the circumstances. For example, it would be less where the lawyer's past relationship with the client is sufficient to give him a basis for trusting the client's probity than where the client has recently engaged the lawyer, and less where the lawyer's inquiries are answered fully than when there appears a reluctance to disclose information.

Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, or for any other reason he does not make the appropriate further inquiries, he should refuse to give an opinion. However, assuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate. . . .

The essence of this opinion . . . is that, while a lawyer should make adequate preparation including inquiry into the relevant facts that is consistent with the above guidelines, and while he should not accept as true that which he should not reasonably believe to be true, he does not have the responsibility to "audit" the affairs of his client or to assume, without reasonable cause, that a client's statement of the facts cannot be relied upon.

60. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2002).

circumstances in which that action is the only one that is in the "best interest of the organization." The Rule, however, is ambiguous. It recites a number of factors a lawyer should consider and then lists three measures, including going up the corporate ladder to the board of directors, that the lawyer "may" take, along with other unspecified measures. Many lawyers view the provision only as giving the lawyer discretion to choose among a number of options, including doing nothing at all, an interpretation that creates a clear risk of liability.⁶¹

The uncertainty on this question is a continuing problem. Many lawyers may not realize that a lawyer who fails to take effective steps to prevent the harm is exposed to the risk of civil liability. In the case against Jones Day arising out of its representation of Lincoln Savings & Loan, the court, denying the law firm's motion for summary judgment, stated that "where a law firm believes the management of a corporate client is committing serious regulatory violations, the firm has an obligation to . . . urge cessation of the activity."⁶² Failure to go to the board of directors could not be excused because thought to be "futile."

Why isn't it always in the best interests of the corporation for fraud to be reported up the ladder as high as necessary?⁶³ "Loyal disclosure" within the hierarchy of an entity client protects the client from disloyal managers and furthers the diligence and loyalty of the lawyer to the interests of the organization itself. As one commentator noted, "[h]onest corporate officers intent on complying with legal requirements, who are certainly the vast majority, should welcome the enhanced vigilance and protection from their legal counsel."⁶⁴

The ABA Preliminary Report reaches the same conclusion: "When the lawyer knows or reasonably should know [that a corporate 'officer or employee is acting illegally or fraudulently, or in breach of a duty to the corporation,'] the lawyer should be encouraged to act promptly to protect the interests of the corporation."⁶⁵ The Preliminary Report recommends that Rule 1.13

61. The ABA Preliminary Report criticizes the current text of Model Rule 1.13 and its comments on additional grounds. The tone of the Rule and its comments "tends to discourage action by the lawyer to prevent or rectify corporate misconduct" by giving large emphasis to the avoidance of "disruption" of the organization and requiring the lawyer to have "[c]lear justification . . . for seeking review over the head of the constituent normally responsible . . ." ABA Preliminary Report, *supra* note 7, at 203-04. In addition, the current rule requires that the matter be "related to the lawyer's representation" while it should include any matter "that has come to the lawyer's attention through the representation." *Id.*

62. *In re Am. Cont'l/Lincoln Sav. & Loan Sec. Litig.*, 794 F. Supp. 1424, 1453 (D. Ariz. 1992); see also *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) (dismissing law firm's motion for summary judgment when lawyer failed to take allegations of officer misconduct to the board of directors).

63. See Richard W. Painter, *Obliging Lawyers to Report Acts of Organizational Clients*, PROF. LAW., Spring 1998, at 10 (arguing that lawyers should be required by ethics rules and SEC regulation to climb the corporate ladder to prevent a prospective or ongoing fraud by managers of the corporate client).

64. George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 GEO. J. LEGAL ETHICS 597, 653 (1998); see also 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT* § 1.13.111 (2d ed., 1998 Supp.) (arguing that the present form of Model Rule 1.13 provides less protection to clients than it would if it required resort to the entity's highest authority).

65. ABA Preliminary Report, *supra* note 7, at 204.

be amended to make clear that it requires the lawyer to pursue the measures outlined in Rule 1.13(c)(1) through (3) (including referring the matter to higher corporate authority), in a matter either related to the lawyer's representation (as currently provided) or that has come to the lawyer's attention through the representation, where the misconduct by a corporate officer, employee or agent involves crime or fraud, including violations of federal securities laws and regulations.⁶⁶

Section 307 of the Sarbanes-Oxley Act⁶⁷ has changed the legal landscape on this question. Lawyers representing public companies will be required to report to higher authority within the organization when they have credible evidence of a material violation of the federal securities laws or of a breach of fiduciary duty by the company or any of its agents. The recommendations of Richard Painter and the ABA Task Force will have been put in place in somewhat different form by an SEC rule promulgated as required by the Act.

The practical problem, especially for inside counsel, is that of angering the person within the organization with the power to fire the lawyer. That person may be part of the problem. Tough choices, but who said that being an honorable lawyer was an easy job? Corporate lawyers are paid \$200 to \$700 per hour for a good reason—they deal with difficult and complex matters that require specialized knowledge, excellent professional skills and, most of all, good judgment.

DISCLOSURE ADVERSE TO A CLIENT'S INTEREST

As a last resort, when a client's officers and board have refused to cease or rectify a corporate fraud on third parties, should the corporation's lawyer become a whistleblower? Should rules of professional ethics or regulatory law permit (or require) the lawyer to disclose confidential information outside the organization when the managers and the board refuse to cease or rectify the ongoing fraud? If the black letter of ABA Model Rule 1.6 is taken to mean what it says, a lawyer is forbidden from disclosing confidential information either to prevent or rectify client fraud on a third person, even when the lawyer learns of the fraud and it involves the use of the lawyer's services. Buried in the comments, and inconsistent with the black-letter text of the Rule, is language permitting a lawyer to "disaffirm documents"—such as legal opinions prepared for a client—"that are being, or will be, used in furtherance of the fraud, even though such a 'noisy' withdrawal may have the collateral effect of inferentially revealing client confidences."⁶⁸ The ABA opinion just quoted infers this permission to reveal confidential information from Rule 1.2(d), prohibiting a lawyer from assisting a client in criminal or fraudulent conduct, and Rule 1.16(a)(1), requiring a lawyer to withdraw when the client will use the lawyer's services to further a crime or fraud. In addition, the self-defense exception of Rule 1.6(b)(2) permits disclosure when a lawyer's representation is

66. *Id.*

67. See *infra* notes 143–52 and accompanying text.

68. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366 (1992) (discussing a lawyer's duties in client fraud situations, including the possibility of a "noisy" withdrawal).

attacked. In the few jurisdictions which have followed the ABA's lead on exceptions to the professional duty of confidentiality, a "noisy" withdrawal in some client fraud situations is possible despite its omission in the black-letter text of the Rule—and may be necessary to avoid civil liability.

The vast majority of U.S. jurisdictions, however, have not adopted Model Rule 1.6 as recommended by the ABA. Forty-one states permit a lawyer to disclose confidential information to prevent a client's criminal fraud; four of those states require a lawyer to make such a disclosure; and only nine states and the District of Columbia may be viewed as forbidding a lawyer to reveal such information.⁶⁹ In the forty-one states that permit or require a lawyer to reveal information to prevent a criminal fraud, Rule 4.1(b) has additional bite. Because disclosure is not prohibited, a lawyer must "not knowingly . . . fail to disclose a material [fact to a third person] when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client . . . [,]" effectively creating an affirmative duty of disclosure in those situations.⁷⁰

During the 1970s the SEC made some noises suggesting that it might adopt a rule or decisional standard that would require a lawyer to disclose a client's securities violations to the SEC. In *SEC v. National Student Marketing Corp.*,⁷¹ the SEC took the position that lawyers, knowing that their client had gone ahead with a merger on the basis of materially misleading financial information in the shareholder proxy statements, had a duty to prevent the merger from taking place; the court agreed that the lawyers had aided and abetted the securities fraud but was much more vague about what the lawyers should have done and imposed no sanction on them. Faced by a storm of professional outrage, the SEC took a considerably more modest position in *In re Carter & Johnson*.⁷²

When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a *substantial and continuing failure* to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end [his] client's noncompliance.⁷³

In a later case, *In re Gutfreund*,⁷⁴ the SEC held that Feuerstein, Salomon's chief legal officer, knowing that a Salomon trader had submitted false bids on Treasury securities, was "obligated to take affirmative steps to ensure" that the misconduct

69. See Attorneys' Liability Assurance Society, Inc., *Ethics Rules on Client Confidences* (2001), reprinted in THOMAS D. MORGAN & RONALD D. ROTUNDA, MODEL CODE OF PROFESSIONAL RESPONSIBILITY, MODEL RULES OF PROFESSIONAL CONDUCT AND OTHER SELECTED STANDARDS (2002) 134–144 (tabulating the current law of all U.S. jurisdictions on disclosure of confidential information to prevent harm to third persons).

70. MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (2002).

71. 457 F. Supp. 682 (D.D.C. 1978).

72. SEC Release No. 34-17597, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981).

73. *Id.* at 84,172 (emphasis added).

74. Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,597 (Dec. 3, 1992).

was adequately addressed.⁷⁵ Those steps might include “disclosure of the matter to the entity’s board of directors, resignation from [the representation], or disclosure to regulatory authorities.”⁷⁶ Having raised the specter of disclosure of client wrongdoing to a public officer, the SEC added that applicable state ethics rules “may bear upon what course of conduct [the] individual may properly pursue.”⁷⁷

Under *Carter & Johnson* and *Gutfreund*, the lawyer must do something, but what? The decisions, by their reference to “professional standards” and their emphasis on the obligation to withdraw if the client does not cease or rectify the violation, reflect the ambiguity of the states’ ethics rules, which generally give the lawyer choices but no mandates (other than remonstrating with the client and then required withdrawal if the client persists in the wrongdoing). At least until Enron, the SEC, aware of the legal profession’s bitter opposition to SEC regulation and discipline of lawyers, has shown little interest in taking a more aggressive position.

LAWYER CONDUCT IN THE ENRON AFFAIR

ANDERSEN’S DOCUMENT DESTRUCTION

The testimony of Andersen officials to congressional committees, supplemented by documents that have subsequently been published and Duncan’s guilty plea, indicates that a massive shredding of Andersen documents relating to its Enron engagement began on October 23, 2001 and continued for eighteen days until terminated on November 9, 2001. The shredding damaged Andersen’s reputation, placed it in a disastrous liability situation, and led to a criminal indictment charging the firm with obstruction of justice. The indictment itself doomed Andersen and the subsequent conviction sealed its fate.⁷⁸ It is extraordinary that such a massive shredding could have occurred without inside or outside lawyers providing clear directions that all Enron-related material should be preserved and establishing procedures to ensure that that occurred. This single event led to Andersen’s disintegration, with horrendous results for its retired and current employees.

Factual Summary⁷⁹

After being fined by the SEC and settling a damage action for its conduct relating to Waste Management’s failure and bankruptcy, Andersen revised its

75. *Id.* at 83,609.

76. *Id.*

77. *Id.* at 83,609 n.26.

78. See Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron*, N.Y. TIMES, June 16, 2002, at A1 (reporting Andersen’s conviction on June 15, 2002 of one count of obstructing justice).

79. As indicated earlier, this brief summary of facts relating to Andersen’s destruction of Enron-related documents relies on: (1) testimony of top Andersen officials and Nancy Temple to congressional committees, especially the hearing of the House Energy & Commerce Committee on January 24, 2002, *Destruction of Enron-Related Documents by Andersen Personnel: Hearing Before the Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce*, 107th Cong. 30–183 (2002) [hereinafter *Destruction of Enron-Related Documents*], available at <http://energycommerce.house.gov/107/>

"document retention policy." The government offered evidence that the policy statement was motivated at least in part by a desire to ensure that in a future situation damaging work papers would not be available to regulators and plaintiffs' lawyers.⁸⁰ In September and early October 2001, as concern increased within Andersen about impending scrutiny of its work for Enron, a group of high-level Andersen partners in Houston and Chicago discussed matters relating to the Enron account in meetings and teleconferences. The group included Nancy Temple, an in-house lawyer in Chicago; Michael Odom, audit practice director; and David Duncan, the Houston partner in charge of the Enron engagement. During those conferences, Temple says she asked Duncan, perhaps on more than one occasion, whether he was in compliance with Andersen's policy dealing with retention and destruction of documents [hereinafter "retention/destruction policy"]. On October 12, Temple sent an e-mail to Odom, which he then forwarded to Duncan. The e-mail said: "It might be useful to consider reminding the engagement team of our documentation and retention policy. It [would] be helpful to make sure that we have complied with the policy. Let me know if you have any questions. Nancy."⁸¹

Temple also attached a copy of Andersen's retention/destruction policy with her e-mail. That policy covered systematic destruction of documents, not just "documentation and retention." When Odom forwarded the e-mail and the policy to Duncan, he included a note saying, "more help."⁸² Duncan told the House committee staff that never before, during his lengthy tenure at Andersen, had he been asked about compliance with the firm's retention/destruction policy. He viewed the communications from Temple as inviting him to destroy documents.

On October 21, 2001, Duncan learned that the SEC had, on October 16, opened an informal inquiry into Enron's financial dealings, particularly the elaborate partnership transactions and Enron's fuzzy disclosures of those deals. On October 22, Duncan and other engagement team members met with Rick Causey, Enron's chief accounting officer, to discuss the SEC inquiry. The following day, Duncan called an urgent meeting of the Enron engagement team, at which, according to an Andersen executive, "he organized an expedited effort to shred, or otherwise dispose of, Enron-related documents."⁸³ During the next two and one-half weeks (eighteen days), "a very substantial volume of documents and e-mails were disposed of by the Enron engagement team."⁸⁴

On November 8, 2001, Andersen received an SEC subpoena for Enron-related documents. Temple, the following day, left a message with Duncan's assistant that all Enron documents should be preserved. The shredding activity stopped on

action/107-80.pdf; and (2) David Duncan's guilty plea, *United States v. Duncan*, 2002 WL 534544 (S.D. Tex. 2002). It is confirmed by newspaper reports of the first seven days of the criminal trial against Andersen. See Jonathan Weil & Alexei Barrionuevo, *In the Balance: As Trial Nears End, Andersen Case Proves Surprisingly Tough*, WALL ST. J., June 4, 2002, at A1 (summarizing the first two weeks of the trial).

80. See *Destruction of Enron-Related Documents*, *supra* note 79.

81. *Id.* at 45.

82. *Id.* at 148.

83. *Id.* at 32.

84. *Id.*

November 9 when the assistant sent an e-mail to secretaries telling them, "no more shredding."⁸⁵

Legal Analysis

What were Andersen's lawyers (in-house and outside counsel) doing while Andersen's accountants and staff were shredding documents? The facts disclosed thus far suggest three possibilities, none of them good. Andersen's lawyers were either: (1) encouraging this destruction through none-too-subtle hints; (2) recklessly ignoring the very real possibility that documents might be destroyed by employees seeking to protect themselves or Andersen; or (3) acting carelessly in relation to whether the Enron files were preserved or not. Any of these explanations exposed Andersen to civil liability to Enron and its shareholders and resulted in Andersen's criminal indictment and serious jeopardy.

While there is some doubt whether or not knowledge of an SEC investigation satisfies one element of the general obstruction of justice act,⁸⁶ it is reasonably clear that 18 U.S.C. § 1512, discussed below, was violated by Andersen's destruction of documents. Section 1512 does not require that a proceeding be pending or imminent, but only that the defendant has some reasonable basis for understanding that a future proceeding is likely or probable.⁸⁷

Duncan was the partner in charge of the Enron account, and federal criminal law often imputes any wrongdoing on the part of an agent to an entity such as Andersen. Duncan's plea of guilt satisfies the requirements of 18 U.S.C. § 1512: he "knowingly . . . engage[d] in misleading conduct toward another person [employees working under him on the Enron account], with intent to . . . cause or induce [that] person to—(A) withhold . . . a record, document, or other object, from an official proceeding; [or] (B) alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official

85. *Id.*

86. 18 U.S.C. §§ 1503, 1505, 1512 (1994). The case law requires that some form of official proceeding be pending and that the defendant have notice of the proceeding. See *United States v. Aguilar*, 515 U.S. 593, 599 (1995). An SEC informal inquiry initiated on October 16, 2001, which became a formal inquiry on October 30, 2001, may or may not meet this standard. See *United States v. Kelly*, 36 F.3d 1118, 1127 (D.C. Cir. 1994) (summarizing an earlier case dealing with an informal SEC investigation as holding that "the SEC's authority to issue subpoenas and administer oaths in conjunction with its investigations made an SEC investigation a § 1505 proceeding").

87. See 18 U.S.C. § 1512; see also C. Evan Stewart, *Andersen: Reviewing Ethics of Document Shredding*, N.Y. L.J., Apr. 15, 2002, at 1, 6 (discussing application of ethics rules). See generally, John C. Coffee, Jr., *Criminal Law: The Andersen Fiasco*, NAT'L L.J., Feb. 11, 2001, at A19 (concluding that the Andersen situation meets any of the lower court tests for when a proceeding is sufficient under 18 U.S.C. § 1512, including the strict one expressed by *United States v. Shively*, 927 F.2d 804, 812 (5th Cir. 1991)). The Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, created additional penalties for document destruction. 18 U.S.C. § 1505 makes it a crime, punishable by a fine and up to five years imprisonment, to alter, destroy, mutilate, or conceal a document with the intent to make it unavailable in an official proceeding or otherwise obstruct any official proceeding. The Act also creates an additional crime, 18 U.S.C. § 1519, with the same penalties, to alter, destroy, mutilate, conceal, falsify, or make a false entry in any document with the intent to obstruct a federal investigation or bankruptcy case "or in relation to or contemplation of any such matter or case." Corporate and Criminal Fraud Accountability Act of 2002, Pub. L. No. 107-204, § 802, 116 Stat. 800.

proceeding[.]”⁸⁸ In addition to the imputed liability for Duncan’s conduct, the government presented evidence in the criminal trial that high-level officials of Andersen, in its Chicago headquarters, were worried about the availability of harmful Enron documents to the SEC and plaintiffs’ lawyers, and that the requests to Duncan that his team follow Andersen’s retention/destruction policy were an indirect way to communicate a desire that harmful working papers and e-mails be destroyed.

In-house lawyer Temple appears to have failed in her duty to advise Andersen employees that under these circumstances any destruction of Enron documents would be a federal (and perhaps state) crime. Andersen’s retention/destruction policy was ambiguous and Duncan, a non-lawyer, was left to decipher its competing provisions that, on the one hand, documents that were not essential in proving that audits were done properly should be destroyed and, on the other, that documents should not be destroyed in situations involving “litigation” or perhaps also “threatened litigation.”⁸⁹ The clear application of the latter statement was surely indicated, but that direction never occurred until November 10, 2001, after the shredding was over.

An outside law firm, Davis, Polk & Wardwell (“Davis Polk”), was also looking after Andersen’s interest during most of the document destruction period. Davis Polk was retained by Andersen on October 9, 2001, and began work on October 16. Temple has testified that on October 16, 2001 she consulted with Davis Polk lawyers concerning document retention. We do not know the scope of Davis Polk’s representation of Andersen other than public statements that the firm was advising Andersen concerning its legal problems relating to the Enron engagement. If in-house counsel had told Davis Polk that it had already taken care of requiring the preservation of documents, the firm could reasonably rely on that assurance and devote itself to other matters. Under other scenarios, the firm’s advice or lack thereof may raise questions of adequacy of representation.

This recital makes one thing clear: Some lawyer or lawyers failed to protect Andersen’s interest in preserving all of its Enron-related documents. One of the initial steps in any internal investigation is the preservation of relevant documents. There is always a danger that some employees may believe that destruction of

88. 18 U.S.C. § 1512(b).

89. The executive summary of Andersen’s policy statement stated: “[i]n cases of threatened litigation, no related information will be destroyed.” Arthur Andersen Business Unit, *Enron Corp., Practice Administration: Client Engagement Information—Organization, Retention and Destruction, Statement No. 760*, at *2 (2000), available at 2000 WL 33680396. But the section to which the summary refers, section 4.5.4, provides for document retention when the responsible accountant “is advised of litigation or subpoenas regarding a particular engagement.” *Id.* at *10. It is unclear whether the omission of “threatened” in the text of the policy statement was an inadvertent omission or intentional obfuscation. In any event, the policy statement had to be viewed in the light of state and federal criminal laws, which often prohibit destruction of relevant documents when litigation is reasonably foreseeable or imminent. Lawyer Temple claimed in her congressional testimony that her statements were intended to invite Duncan to read and follow the firm’s policy. The policy, however, was ambiguous on its face and a careful lawyer should have applied it to the particular context in the light of applicable criminal prohibitions (e.g., federal law and Illinois and Texas law). Application of this relevant law, a matter for a lawyer rather than an accountant, clearly required the retention of all relevant documents as of October 21.

troublesome documents will serve their or the company's interest. Preventing such actions is essential to the company's reputation and, in this case, its very survival. How could Andersen demonstrate its innocence of participation in Enron's fraud, assuming it was innocent, when many files had been destroyed after an SEC inquiry had begun? Without its files, how could it reestablish its reputation by convincing the public that it had gotten to the bottom of any problem and made the necessary changes? Why would it want to risk being criminally charged? Many failures contributed to Andersen's disintegration, but lawyer failure was surely one of them.

V&E'S "PRELIMINARY INVESTIGATION" OF WATKINS' ALLEGATIONS

Factual Background and Assumptions⁹⁰

Sherron Watkins' anonymous letter of August 14, 2001, supplemented by several later communications in which she identified herself, stated that "Enron has been very aggressive in its accounting."⁹¹ Watkins' allegations raised serious questions concerning the accounting treatment and economic substance of the LJM and Raptor transactions, Andrew Fastow's conflicts of interest, and correctly predicted that negative publicity and litigation would occur when the public learned about the transactions.

Enron's CEO, Kenneth Lay, met with Watkins on August 22, 2001. After agreeing to initiate an investigation, Lay discussed the situation with James V. Derrick, Jr., Enron's general counsel. Lay and Derrick agreed that Enron should retain an outside law firm to investigate and that V&E, if it could do so ethically, should conduct the investigation. Lay and Derrick recognized that V&E had done legal work creating some of the limited partnerships at issue and had advised on the securities disclosures concerning them. Nevertheless, they concluded that V&E was in the best position to help Enron determine whether a full-scale investigation by independent lawyers and accountants was necessary. According to Enron and V&E, the firm's familiarity with Enron and the transactions would allow it to do the job quickly, and that explains why V&E was chosen. V&E agreed to do the investigation and two V&E lawyers (the partner responsible for the Enron relationship and a litigation partner who had done no prior work for Enron) began work on the matter on August 23 or 24, 2001.

The scope of V&E's investigation was limited in significant respects. It was a "preliminary investigation" to determine "whether the [Watkins allegations] . . . presented any new information . . . that may warrant further independent investigation."⁹² V&E had also agreed with Enron's Derrick and Lay that "our initial approach would not involve the second guessing of the accounting advice and

90. The documents relied on for this summary of assumed facts are cited *supra* notes 16, 20, and 21.

91. Letter originally anonymous from Sherron Watkins to Kenneth L. Lay, Chief Executive Officer, Enron Corp. 1 (Aug. 14, 2001), available at <http://news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf>.

92. Hendrick Opinion Letter, *supra* note 20, at *2.

treatment provided by [Andersen]" and "that there would be no detailed analysis of each and every transaction."⁹³ In fact, there does not appear to have been a detailed analysis of any transaction.

During late August and early September 2001, V&E interviewed eight high-level Enron officials and two Andersen partners (Duncan and Cash), studied documents relating to the LJM partnerships, met informally with V&E lawyers who had worked on these matters, and, finally, met with Watkins.⁹⁴ On September 21, 2001, they reported orally to Lay and Derrick; the same conclusions were later embodied in V&E's October 15 opinion letter.⁹⁵

V&E's opinion concluded that "the facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors."⁹⁶ This statement was accompanied by a statement that "the bad cosmetics involving the LJM entities and Raptor transactions, coupled with the poor performance of the merchant investment assets placed in those vehicles and the decline in the value of Enron stock" created "a serious risk of adverse publicity and litigation."⁹⁷

The following day Enron announced that it was taking a nearly \$600 million charge against earnings and a reduction of shareholders' equity of \$1.2 billion related to Raptor transactions. Investor confidence was undermined, Enron stock plummeted, credit triggers were set off, and some six weeks later Enron sought bankruptcy protection.

Ethical and Legal Issues Concerning V&E's Investigation

Should V&E have undertaken an investigation the scope and purpose of which were unclear? Should V&E have accepted limits on its investigation that restricted whom it should interview and what it should accept, such as Andersen's resolution of accounting matters, without further review? Did the investigation require V&E to evaluate its own prior work? Did V&E provide adequate representation to Enron in conducting its investigation?

The scope of the intended investigation remains unclear. On its face it was a very narrow one: to determine whether Watkins' communications advanced any "new facts" that would justify a full investigation, with all accounting issues left unexamined. But Watkins raised disclosure and conflicts issues as well as accounting issues; and the investigation actually carried out considered much broader questions such as the "bad cosmetics" of the accounting actions, the likelihood of shareholder litigation, and the conflicts of interest raised by the LJM transactions. While a client's regular lawyer can undertake a narrow investigation whether "new facts" have been raised, the broader one ("Do we have a problem here?") suggested by the inquiry actually made, and by the report itself,

93. *Id.* at *1.

94. POWERS REPORT, *supra* note 16, at *80.

95. *Id.*

96. Hendrick Opinion Letter, *supra* note 20, at *7.

97. *Id.*

does involve disclosure issues and V&E's prior work. Moreover, the context suggests that Lay and Derrick wanted and got an opinion that would be read to provide cover on the broader question: "There is no problem that deserves a full investigation."

Under the profession's conflict of interest rules, a lawyer may not represent a client if there is a substantial risk that the lawyer's representation of the client would be materially and adversely affected by the lawyer's own interest, unless the client gives a fully informed and valid consent.⁹⁸ Model Rule 1.7, either in its 1983 form or as recently revised, contains the same prohibition in different language, as does Rule 1.06 of the Texas Rules of Professional Conduct.⁹⁹ But there is more. A client's consent is not effective if, "in the circumstances, it is not reasonably likely that the lawyer will be able to provide adequate representation" ¹⁰⁰

It is clear that V&E could not undertake the investigation without Enron's informed consent. Enron was V&E's largest client and it had done extensive legal work in structuring and documenting the transactions in question and approving financial disclosures concerning them. The investigation required V&E to assess objectively, as if it had not been there at all, the soundness and propriety of its prior representation. Thus, the situation presented a serious conflict between Enron's presumed interest in an objective investigation and V&E's own interests.

Normally, a client experienced in the use of legal services who is advised by in-house counsel concerning an actual or potential conflict of interest may give a valid consent if fully informed of the risks and implications of the conflict of interest. I assume that Enron was fully informed and consulted. Nevertheless, there is a question whether the consent was a valid one, and, even if it was, whether the second requirement—the objective standard that the lawyer reasonably believe the representation will not be adversely affected by the lawyer's conflict of interest—was satisfied.

The situation is analogous to ones arising when a derivative suit charges a corporate manager with wrongful conduct harmful to the corporation.¹⁰¹ The manager's consent to a lawyer's conflict is insufficient under these circumstances; the consent must be given by an officer or by board members who are not charged with misconduct. In the V&E situation, general counsel Derrick and CEO Lay were high-level officials implicated in the misconduct alleged by Watkins. The

98. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 121, 122 (2000).

99. Compare MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002), with TEXAS RULES OF PROF'L CONDUCT R. 1.06 (1989).

100. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 122(2)(c) (2000).

101. See, e.g., *Yablonski v. United Mine Workers of Am.*, 448 F.2d 1175 (D.C. Cir. 1971); *Cannon v. U.S. Acoustics Corp.*, 398 F. Supp. 209 (N.D. Ill. 1975), *aff'd in relevant part*, 532 F.2d 1118 (7th Cir. 1976); HAZARD, KONIAK & CRAMTON, *supra* note 1, at 726–31. Consent to a lawyer's conflict of interest cannot be given under those circumstances by the corporate managers who may be involved in the wrongdoing, but only by disinterested officers or board members. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 122 cmt. c(ii) (2000), dealing with the capacity of the consenting person: "When the person who normally would make the decision whether or not to give consent . . . is otherwise self-interested in the decision whether to consent, special requirements apply to consent."

explanation that V&E was familiar with the transactions and therefore could provide the report quickly is a dubious basis for waiver of V&E's serious conflict.

Corporate law requires, in some instances, that internal investigations be conducted by "independent counsel."¹⁰² Moreover, the standard advice for internal investigations dealing with a wide range of issues (e.g., illegal foreign payments, illegal campaign contributions, special litigation committees in derivative suit situations, and indemnification decisions) is that "independent counsel" be used.¹⁰³

In any event, there remains a serious question as to whether V&E's own conflict of interest would not "adversely affect" its performance of the investigation. V&E's opinion letter stated that the Enron transactions it facilitated and documented were "creative and aggressive," suggesting that they went to the outer edge of legality.¹⁰⁴ Transactions may be within the bounds of the law even though they entail legal risks. But a course of action that involves pushing things to the edge in an effort every quarter to increase the reported earnings creates enormous risk that some of the many transactions and devices will turn out to be illegal or fraudulent. The bounds of the law are always indeterminate and fuzzy. As Brandeis said, lawyers should advise conduct that is a safe distance from the uncertain precipice of illegality rather than attempt to tread the edge of the precipice.¹⁰⁵

V&E's letter also concluded that "because of the bad cosmetics involving the LJM entities and Raptor transactions, coupled with the poor performance of the merchant investment assets placed in those vehicles and the decline in the value of Enron stock, there is a serious risk of adverse publicity and litigation."¹⁰⁶ It was reasonably foreseeable, as has happened, that that litigation would include V&E as a defendant and that Enron officers, directors, and other co-defendants would defend themselves by blaming V&E for giving poor advice. Under these circumstances, the conflict appears to be too severe to be undertaken: a reasonable lawyer would not believe that his representation would not be adversely affected.

The adequacy of the investigation is also questionable. Aside from two investor relations officers, V&E interviewed only seven high-level officials, most of whom

102. For example, the MODEL BUS. CORP. ACT § 8.55(b)(2) (1998-99 Supp.) requires that "special legal counsel" be used to make decisions whether to indemnify officers and directors. Some states in the indemnification context phrase the requirement in terms of "independent counsel"—defined in Ohio as a law firm that has not represented the corporation or any person to be indemnified within the past five years. See, e.g., OHIO REV. CODE ANN. § 1701.13(E)(4) (Anderson 2001).

103. See Arthur F. Matthews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655 (1984).

104. Hendrick Opinion Letter, *supra* note 20, at *6.

105. When lawyers habitually push the envelope of the permissible, their actions will occasionally involve illegality. As Louis Brandeis put it in replying to claims of business executives that antitrust law was intolerably fuzzy:

"[Y]our lawyers . . . can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go to that precipice without falling over, because you may stumble on a loose stone . . . ; but anybody can tell you where you can walk perfectly safe within convenient distance of that precipice." The difficulty which men have felt . . . has been rather that they wanted to go to the limit rather than they wanted to go safely.

Hearings Before Sen. Comm. on Interstate Commerce, S. Res. No. 98, 62nd Cong. 1161 (1911) (statement of Louis D. Brandeis), quoted in HAZARD, KONIAK & CRAMTON, *supra* note 1, at 62.

106. Hendrick Opinion Letter, *supra* note 20, at *7.

were directly implicated in the self-dealing and fiduciary violations raised by the Watkins allegations and corroborated by McMahon. V&E relied on the denials of wrongdoing by those officers and on the fact that none of the persons interviewed could identify a specific transaction that was illegal. Although McMahon, one of those interviewed, mentioned ten lower-level employees who might be good sources of information concerning Fastow's self-dealing, V&E failed to interview any of them. V&E was informed by Causey of the "mistake" that was made concerning accounting failures on the LJM2 transactions (resulting in the October 16, 2001 restatement of shareholder equity), but never pursued how and why this occurred. The investigation as a whole, when compared to the subsequent investigation by the board's special committee, using the services of Wilmer, Cutler & Pickering, appears perfunctory. As the Powers Report stated, the result of the V&E investigation "was largely predetermined by the scope and nature of the investigation and the process employed."¹⁰⁷ It was performed with insufficient skepticism.¹⁰⁸ Did V&E give some thought to why Enron's managers wanted V&E to investigate matters related to its own prior work and what opinion they wanted the firm to provide? There is a serious question of whether adequate representation was provided to the entity client, as distinct from satisfying the managers' apparent desire to have a protective document.

V&E, supported by two opinions of legal ethics experts, relies on the characterization of its investigation as "preliminary" and concludes that there was no conflict of interest because its own prior work was not involved and "no new facts" were produced by its inquiry.¹⁰⁹

First, it is a truism that a corporation's regular counsel may inquire whether allegations of manager misconduct warrant a full-scale investigation. The issue here is whether the "preliminary" investigation was structured at the managers' request in a way that made it a *final* investigation, a conclusion not based on an adequate inquiry of whether a full-scale investigation by independent counsel was necessary.

Second, V&E and its experts argue that no independent investigation was necessary. That argument can be made only if legal issues are totally subsumed in the accounting issues left to Andersen and the "economic substance" questions left to Enron's managers and board.¹¹⁰ But legal as well as factual questions were involved

107. POWERS REPORT, *supra* note 16, at *81.

108. *Id.*

109. Opinion letter from Charles W. Wolfram, Professor of Law Emeritus, Cornell Law School, to John K. Villa, Esq., Williams & Connolly LLP (Mar. 13, 2002); Opinion letter from Geoffrey C. Hazard, Jr., Trustee Professor of Law, University of Pennsylvania, to John K. Villa, Esq., Williams & Connolly LLP (Mar. 13, 2002).

110. A statement of V&E's senior partner, responding to criticism of the firm's role in Enron's failure, apparently takes that position: "[outside counsel has] 'no role in determining whether, or what, accounting treatment was appropriate' for a client." John Schwartz, *Enron's Many Strands: The Lawyers; Troubling Questions Ahead for Enron's Law Firm*, N.Y. TIMES, Mar. 12, 2002, at C1. Lawrence Cunningham criticizes this artificial separation of "legal" and "accounting" issues, arguing that related party transactions invariably create legal and accounting issues. See Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 BUS. LAW. 1421, 1454 (2002). A lawyer's characterization of the legality of the transaction as a "sale" and the financial disclosures required concerning it are legal questions that have to be decided with knowledge and understanding of the related accounting principles. The interim conclusions of Enron's court-appointed bankruptcy examiner are that the appropriate legal characterization of many of Enron's SPE transactions was "loan"

and, if they were not, why would Enron be interested in V&E's advice and legal opinion? The extraordinary nature of many of the related-party transactions raised issues of their legality and whether the financial disclosures concerning them met legal requirements. If the transactions were merely accounting gimmicks designed to artificially inflate Enron's profits and conceal its debts, they were illegal and fraudulent transactions.

Lawyers cannot absolve themselves from legal responsibility by pretending that only accounting issues are involved, just as accountants cannot relieve themselves of responsibility by relying on the judgments of lawyers. If a series of transactions have no substantial business purpose (i.e., no property or risk is transferred to a third party) and the facts and circumstances suggest that their sole function is to give the balance sheet a false boost, legal questions are raised that are not resolved by an accountant's approval.¹¹¹ If representations are repeatedly made in financial disclosure documents to the effect that related-party transactions were "at arms' length," meaning that the managers have reason to believe that comparable market transactions involving independent parties would be made on the same terms, the lawyers must ask for some factual verification other than the mere assertion of interested managers. Legal questions do not evaporate because accountants and managers are also making judgments.

Finally, V&E's conclusion that "no new facts" emerged from its "preliminary" inquiry is incorrect.¹¹² Watkins and McMahon both identified serious conflicts of interest on the part of Fastow that had been communicated to Skilling, Buy and Causey; allegations those executives had ignored. Although Fastow's dual role was not new information (it had been approved by the board), the way the conflicts had played out, and the failure of the controls to mitigate the conflicts, were new information. Watkins and McMahon, cumulatively, identified twelve Enron employees and three former employees who they said were knowledgeable about Fastow's conflicts; none of those individuals were interviewed by V&E. The identities of persons who could provide more detailed information about possible breaches of fiduciary duty by corporate managers were themselves "new facts" warranting further inquiry.

COMMON LAW CLAIMS AGAINST LAWYERS

Under the common law, a lawyer was liable for negligence only to those in privity of contract with the lawyer, typically clients. Although the privity doctrine has been abolished in negligence cases involving physical harm, it retains considerable vigor in negligence suits claiming purely economic harm, such as a negligent misrepresentation case brought against a lawyer by a non-client. Today, however, many jurisdictions have adopted exceptions to privity of contract in

rather than "sale," and that the financial disclosures concerning the transactions were false and misleading. See Batson, *supra* note 18, at *7-*8.

111. Documenting a transaction as a "sale" and issuing a "true sale opinion" to the lender present legal questions. The First Interim Report of the Bankruptcy Examiner, Batson, *supra* note 18, at *7-*8, after studying six representative Enron transactions, concluded that, as a matter of law, most or all of them were disguised loans rather than sales.

112. See *supra* note 109 and accompanying text.

situations in which (1) the purpose of the lawyer-client relationship was to benefit or influence a third person¹¹³ or, alternatively, (2) where someone in the business of supplying information for others "supplie[d] false information for the guidance of others [on which they have reasonably relied] in their business transactions."¹¹⁴ The resulting duty of care is most commonly found in situations in which the lawyer, in handling a transaction for a client, is dealing directly with the injured third person or the representation seeks to benefit that person.¹¹⁵

Texas law would probably govern any claims brought against V&E other than those arising under federal securities laws. In Texas, the privity of contract doctrine bars a non-client from bringing a negligence action against a lawyer except in a few special situations. In *McCamish, Martin, Brown & Loeffler v. FE. Applying Interests*,¹¹⁶ the Texas Supreme Court followed Restatement (Second) of Torts section 552 in a situation in which a lawyer gave negligent legal advice concerning the legality of a settlement that harmed both the client and the other settling party.¹¹⁷ The latter was permitted to recover for the lawyer's negligent misrepresentation when information falsely supplied for the guidance of others was given to "a limited group of persons" to whom the law firm knew or should have known his client would give the information.¹¹⁸ Does a shareholder have standing to bring a negligent misrepresentation claim against a professional adviser? The answer may depend upon whether the adviser merely gave legal advice concerning a transaction or, in addition, prepared a disclosure document intended to provide information to shareholders and others.

Intentional torts, such as fraud, are not subject to the privity doctrine and may be brought by non-clients. A fraudulent misrepresentation claim under Restatement (Second) of Torts section 531 may be brought for economic damages if the injured parties reasonably relied on the fraudulent misrepresentations and if they belong to a "class of persons" whom the defendant "has reason to expect" would rely on the misrepresentation.¹¹⁹ State law governing the scope of reliance on fraudulent misrepresentations, however, is not shaped by the fraud on the market legal fiction applied in federal securities cases, a fiction that permits any investor to be included in the "class of persons" who has relied on the misrepresentation. In Texas, a prospective purchaser of shares who relied upon a fraudulent misrepresentation contained in an accountant's report is not within the persons protected by that section.¹²⁰ The purchaser does not belong within the class of persons

113. See, e.g., *Greycas, Inc. v. Proud*, 826 F.2d 1560 (7th Cir. 1987) (upholding a negligent misrepresentation claim against a lawyer under Illinois law).

114. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

115. See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 51 (2000) (recognizing three exceptions to the privity requirement: (1) when the lawyer's client invites the non-client to rely on the lawyer's opinion or provision of legal services and the non-client so relies; (2) when one of the primary objectives of the representation is to benefit the non-client; and (3) when the lawyer's client is a fiduciary acting primarily to perform fiduciary duties owed to a non-client beneficiary).

116. 991 S.W.2d 787 (Tex. 1999).

117. *Id.* at 791-93.

118. RESTATEMENT (SECOND) OF TORTS § 552 (1977).

119. *Id.* § 531.

120. See *Ernst & Young, LLP v. Pac. Mut. Life Ins. Co.*, 51 S.W.3d 573, 581-83 (Tex. 2001).

whom the defendant had reason to expect would rely on the misrepresentation. How this decision applies to those who own shares when the misrepresentation is made is unclear. Another uncertainty is whether the repeated statements of Enron executives addressed to Enron employees concerning the value of Enron stock had the effect of putting those employees within the protected class.

CLAIMS AGAINST LAWYERS UNDER FEDERAL SECURITIES LAWS

1. Elimination of Accessory Liability

Central Bank's elimination of accessory liability requires that claims under section 10(b) of the Securities Exchange Act of 1934 be framed as primary violations. *Central Bank*¹²¹ held that a secondary actor in a securities transaction (e.g., an accountant or a lawyer) is not liable for damages for aiding and abetting a securities law violation.¹²² Criminal liability, however, is still a possibility and the SEC has authority to bring administrative proceedings against professional advisers. Civil liability actions against solvent and well-insured accounting and law firms in a fraud situation now must cast them as primary violators of section 10(b). Under *Central Bank*, the plaintiffs must show that a defendant actually engaged in manipulative or deceptive acts or made fraudulent representations. As the *Central Bank* decision put it: "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable" ¹²³

The federal courts of appeals are divided on whether primary liability reaches a professional adviser who stays in the background, writing and approving the fraudulent financial statement or solicitation, but who does not make a misrepresentation in person, provide a legal opinion, or whose name is not included in the document. Several courts of appeals have upheld primary liability when the complaint alleges that the lawyer, aware of their falsity, anonymously drafted false representations that were relied on by investors;¹²⁴ on the other hand, other circuits have struck down such complaints.¹²⁵

121. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). For a discussion of the effect of *Central Bank* on secondary actors, see Fisch, *supra* note 45; Melissa Harrison, *The Assault on the Liability of Outside Professionals: Are Lawyers and Accountants Off the Hook?*, 65 U. CIN. L. REV. 473 (1996); Douglas M. Branson, *Chasing the Rogue Professional After the Private Securities Litigation Reform Act of 1995*, 50 SMU L. REV. 91 (1996).

122. *Central Bank*, 511 U.S. at 191.

123. *Id.*

124. See *Klein v. Boyd*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136, at 90,317, 90,325 (3d Cir. Feb. 12, 1998) (holding that lawyer "spoke" to the investors by drafting the solicitation documents even though his identity was unknown to those solicited); *Dannenberg v. Painwebber Inc. (In re Software Tools, Inc.)*, 50 F.3d 615, 619 (9th Cir. 1994) (holding that substantial participation in drafting is sufficient if there is "a reasonable inference that [the firm] knew or recklessly disregarded this falsehood").

125. *Anixter v. Home-States Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (finding no primary liability for representations made by others); *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1204 (11th Cir. 2001) (holding that the complaint must include an allegation that the law firm made misrepresentations or omissions upon which the investors relied).

My own view is that it is wrong to make liability turn on whether or not the substantial participation of the professional adviser is concealed. Why should an anonymous draftsman escape responsibility for fraudulent representations merely because his identity is concealed? My position does push the margins of primary liability and the uncertainty on this question provides a strong argument for statutory overruling of *Central Bank* to permit aiding and abetting claims to be brought against lawyers and accountants. The lawyer, present at the time the fraud is committed and having reason to know about it, who substantially participates in facilitating the fraud should be accountable to those who are harmed.

2. Securities Fraud Issues

Securities fraud issues relating to Enron's inside or outside lawyers raise legal issues that are difficult, controverted, and uncertain.

Lawyer liability for misleading audited financial statements contained in filings under the Securities Exchange Act of 1934. The extent to which lawyers may rely, without further inquiry, on what the auditors tell them is a controverted and uncertain issue. Uncertainty also exists about whether Andersen's application of generally accepted accounting principles (GAAP) was proper and, even if so, whether liability still exists when the actor knows that the financial statements as a whole do not fairly present the financial position of the company.

Lawyers and accountants often talk as if compliance with GAAP and generally accepted accounting standards (GAAS), or with an SEC guideline such as the three percent outside equity participation required of special purpose entities, is conclusive. The case law is to the contrary. In *United States v. Simon*,¹²⁶ the U.S. Court of Appeals for the Second Circuit in a lengthy opinion by Judge Friendly, affirmed the convictions of three accountants for securities and wire fraud even though seven eminent accounting experts testified that the accountants' certification of the client's financial statements was in full compliance with generally accepted auditing principles and standards (GAAP and GAAS). The accountants, knowing that the manager of a vending machine company had diverted millions of dollars from the company for personal investments in the stock market, included a footnote in the financial statement that referred obliquely to the obligation owed to the company by the manager, but did not disclose either the manager's diversion of funds or the unsatisfactory collateral that supposedly secured it. The decision, affirming the trial court's instructions and the sufficiency of the evidence, holds that technical compliance with the standards established by accountants' organizations is relevant but not conclusive evidence of the accountants' good faith; the crucial question for the trier of fact is whether the accountants' statement was or was not "materially false or misleading."¹²⁷

But there is more. Judge Friendly states that general accounting principles

instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted.

126. 425 F.2d 796 (2d Cir. 1969).

127. *Id.* at 806.

Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him. Then . . . he must "extend his procedures to determine whether or not such suspicions are justified." If as a result [of further inquiry] he finds his suspicions to be confirmed, full disclosure must be the rule, unless he has made sure the wrong has been righted and procedures to avoid a repetition have been established.¹²⁸

Judge Friendly also stated that

it simply cannot be true that an accountant is under no duty to disclose what he knows when he ha[s] reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all [shareholders] but for the private benefit of its president¹²⁹

It is an open question whether a lawyer may be charged and convicted as a principal in a securities action under section 10(b) for conduct similar to that in *Simon*. But *Simon* surely states standards that should also apply to lawyers.

Disclosure of derivatives transactions. Enron's financial disclosures did not reveal the magnitude of the risks associated with the huge derivatives business in which Enron was engaged. Did the auditors comply with SEC guidelines? Did the lawyers know that the disclosures failed to reveal their substantial effect on Enron's balance sheet, the risks involved, and other material facts? Are the lawyers responsible for a failure to disclose the underlying realities in a non-misleading manner?

Insider trading. Sales of Enron stock by Enron executives (and perhaps some in-house lawyers) while Enron's financial condition was deteriorating may present some insider-trading issues. What did Enron's lawyers know about these sales? Should they have done something? If so, what? A further complication is that some of the executives' selling may have been appropriate as part of a planned program of divestiture of stock held as compensation.

Conflict of interest problems. The conflicts of interest arising from Fastow's (and later Kopper's) dual roles in the LJM transactions pose serious problems for everyone who assisted or participated in those transactions. The conflicts were extraordinary; their effect on Enron's reported financial position was very large; enormous effort and casuistry was employed to conceal the compensation that Fastow, Kopper and other LJM partners received; and the failure to comply with equity participation or other accounting requirements on some of the transactions

128. *Id.* at 806–07.

129. *Id.* at 806. Subsequent decisions follow *Simon*. See, e.g., *In re Haw. Corp.*, 567 F. Supp. 609, 617 (D. Haw. 1983) ("Compliance with GAAP and GAAS . . . will not immunize an accountant when he consciously chooses not to disclose on a financial statement a known material fact."); *Siemens Info. Sys., Inc. v. TPI Enters., Inc.*, [1991–1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,573, at 92,659, 92,662 (S.D.N.Y. 1992), available at 1992 U.S. Dist. LEXIS 3018, at *14 (finding that conformity to GAAP is not enough; moreover, to avoid liability full disclosure of any suspicions that are well founded is required); *Fund of Funds, Ltd. v. Arthur Andersen & Co.*, 545 F. Supp. 1314, 1366 (S.D.N.Y. 1982) (rejecting accounting firm's argument that compliance with GAAP was "highly persuasive"; "the consensual, self-regulating accounting standards were not a substitute for the substantive standards under the securities laws" which require the accountant "to present a full and fair picture of its client's financial conduct"); *United States v. Colasurdo*, 453 F.2d 585, 594 (2d Cir. 1971) (finding that the fundamental question is not compliance with GAAP but one of "honesty and good faith").

ultimately led to public exposure of Enron's financial situation and its precipitous collapse. What did the inside and outside lawyers know about the details of the related-party transactions?¹³⁰ Did those lawyers give adequate advice concerning the transactions and the financial disclosures concerning them to top executives and to the board? Did the lawyers advise the adoption of procedures adequate to prevent breaches of fiduciary duty and subsequently monitor whether the procedures were being followed? Did they know that some of the procedures (such as Skilling's approval and signature) were not followed? Did the failure of inside and outside lawyers to pursue concerns or allegations of an inside lawyer (Mintz), Enron's treasurer (McMahon), and an accountant (Watkins) constitute negligence or worse?

3. *The Newby Complaint*

The lawsuit brought by Enron shareholders now includes most of the major participants in Enron's failure: officers, directors, law firms (V&E and K&E), accountants (Andersen), and seven investment banks.¹³¹ The complaint charges that the two law firms were active participants in an ongoing fraud in which manipulative and deceptive devices that they created and approved were a central component. V&E, the complaint alleges, *inter alia*, participated in the fraudulent scheme by assisting in the structuring and documenting of fraudulent transactions that had no purpose other than to falsely misstate Enron's earnings; V&E also provided "true sale" opinions that enabled the related-party transactions to take place even though in some of them no property changed hands; and its "preliminary investigation" was part of the cover-up of the fraudulent scheme. K&E, the complaint alleges, participated in the fraudulent scheme by structuring the related-party transactions "to falsify Enron's financial condition."¹³² V&E spoke directly to creditors and investors in the LJM transactions through legal opinions and to shareholders and investors by approval of financial statements concerning those transactions.

130. Information concerning the extensive participation of V&E in creating Enron's special purpose partnerships, providing true sale opinions concerning some of them, and advising and approving Enron's financial disclosures concerning them is contained in the POWERS REPORT, *supra* note 16, and Ellen Joan Pollock, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue*, WALL ST. J., May 22, 2002, at A1. The Pollock article provides the following details: one of the partner's firms, Ronald Astin, raised conflict of interest objections to the participation of Enron employees (Fastow and Kopper) in managing and profiting from the JEDI and Chewco partnerships in 1997, but did not pursue the matter when Enron went ahead anyway. V&E also represented Enron in a series of off-balance sheet transactions with the LJM partnerships in 1999, providing "true sale" opinions in some of them but declining to do so in others. For the latter, Enron had no difficulty in obtaining opinions from another firm, Andrews & Kurth. V&E also prepared the documents for Raptor transactions with LJM2, but Astin communicated his concerns about some of the deals to an Enron in-house lawyer, Rex Rogers; Astin was concerned because risks and rewards were not shifted from Enron to the partnerships. Opinions on some of those transactions were also obtained from Andrews & Kurth. V&E's concerns were not communicated to Enron's CEO, Lay, even though Reasoner, V&E's managing partner, had a close personal relationship with him, nor were the firm's concerns communicated to the Enron board. V&E also advised and approved Enron's decisions not to disclose in its 2001 proxy statement the compensation Fastow received from managing the partnerships. *Id.*

131. Amended Complaint, *Newby v. Enron Corp.*, No. H-01-3624 (S.D. Tex. filed Apr. 8, 2002).

132. *Id.* at 447.

4. Conclusion

More guidance is needed concerning a lawyer's responsibilities under the securities laws. The continuing controversy, confusion, and uncertainty concerning a lawyer's duties in the various situations that arise in securities and client fraud situations such as Enron need clarification. Bar organizations tend to support the present state of affairs because it permits them to maintain that lawyers have extremely limited or no obligations under current law in situations not subject to the "due diligence" requirement applicable to new offerings. The bar's position does not reflect the uncertainty of present law, which frequently results in large settlements and reputation loss whenever lawyers rely on it. The current situation is both unfair to lawyers and fails to give sufficient protection to the public interest in corporate integrity and honest markets.

PERSONAL OBSERVATIONS AND SUGGESTED REFORMS

The conduct of the inside and outside lawyers who represented Enron, Arthur Andersen, and the many financial institutions involved in the Enron scandal tell the same story that has been told to us by a long string of major financial frauds for fifty years: the professional ideal of "independent professional judgment" does not inform the behavior of some lawyers who represent large corporations in major transactions and high-stakes litigation. These lawyers take the position that they must do everything for the client that the client's managers want them to do, providing the conduct is permitted by law. The problem is that by constantly going to the edge of the law and taking a very permissive view of what the law permits, these lawyers gradually adopt a mindset that ignores and may eventually assist the client's managers in illegality that harms third persons and the client entity.¹³³ These lawyers have confused the role of advocate in litigation or adversary negotiation with the need of corporate clients for independent, objective advice in the course of corporate decision-making. Current practices have resulted in a widespread problem, not just a failure of individual law firms.¹³⁴

133. See, e.g., Geoffrey C. Hazard, Jr., *Lawyers and Client Fraud: They Still Don't Get It*, 6 GEO. J. LEGAL ETHICS 701, 720 (1993) ("Responsible law-giving require[s] recognition . . . that honest lawyers can suffer the misfortune of having dishonest clients."). Lawyers representing such clients risk civil and criminal sanctions for aiding and abetting client fraud if the lawyers protect client confidences too zealously. Thus an honest lawyer "is at risk of being drawn into a transaction which is tainted with fraud . . . [and] can be charged with being an accessory to the client's wrongdoing . . . [Responsible law-giving] requires having no tears for clients who draw their lawyers into fraudulent schemes." *Id.* Responsible law-giving also involves heeding Brandeis' advice that lawyers in counseling clients and facilitating transactions should channel client conduct away from the precipice of illegality onto ground that is solid. See *supra* note 105.

134. Law firms involved in major client fraud situations are identified by name in this Article to make it clear that many prestigious law firms have been the victims (and perhaps the aiders and abettors) of client fraud. It is not a "bad apples" problem requiring greater vigilance on the part of prosecutors or regulators. There are systemic problems that require broader and more meaningful reforms. See also John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) (arguing that the verification and certification functions of gatekeepers—accountants, analysts, and lawyers—failed to operate effectively because legal risks declined during the 1990s and changes in the provision of professional services created conflicts of interest that affected independent judgment). Implicit in Coffee's argument is the conclusion drawn here: professional advisers should be made more accountable to the law to deter them from acquiescing in managers' unlawful requests.

Lawyers rationalize their behavior by viewing others (the managers, the accountants, etc.) as responsible for the decisions that are made, largely ignoring their own responsibility. As potential disaster looms, those involved (managers, accountants, and lawyers) are faced with only bad choices and, cognitive psychology tells us, there is a strong tendency to take even greater risks in what turns out to be an unsuccessful effort to avoid financial failure and disclosure of the prior fraud.¹³⁵ A “circle of blame”—a classic form of deflection of responsibility—results when things predictably go wrong and each group of participants places the blame on the others.¹³⁶ When that occurs it becomes likely that many of the major participants who are solvent and have assets (e.g., the outside law firm with substantial liability insurance coverage) will be forced eventually to make large settlements that partially recompense some of those who were harmed. This scenario played itself out hundreds of times during the savings and loan crisis and is already underway in the Enron affair.

For a variety of reasons, too many lawyers tend to believe that they are largely immune from legal liability when they turn a blind eye to signs that those who are in control of the client corporation are engaged in fraudulent conduct.¹³⁷ Applicable ethics rules, especially the exceptions to the professional duty of confidentiality and the rule dealing with steps to be taken when insiders refuse to take steps to rectify a prospective or ongoing fraud, are controverted, ambiguous, and often discretionary. Although courts have held that a lawyer is required to take some meaningful steps to prevent a future or ongoing fraud, the decisions are few and only rarely apply effective sanctions to lawyers. Confused by the barrister’s rule that the lawyer is not supposed to displace the judge or jury by “judging the client,” lawyers apply the same approach to corporate actions in

135. “Prospect theory” in cognitive psychology finds that decision-makers tend to be risk averse when deciding between two choices that result in a gain, but risk preferring when faced with two choices that result in a loss. Jeffrey Rachlinski has applied this theory to the framing of choices in litigation. See Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113 (1996). He and Richard Painter have applied the same approach to managers and lawyers faced with a decision whether to disclose or conceal information that, whatever they do, involves large risks of loss. Business and legal literature tend to confirm the hypothesis that managers and lawyers will be risk preferring in this situation, opting for concealment of information rather than disclosure. See Richard W. Painter, *Lawyers’ Rules, Auditors’ Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1413–24 (2000) (stating the theory and the literature and events that support it).

136. The “circle of blame” among those involved in Enron transactions is also characteristic of lawyers’ and judges’ views concerning discovery abuse in high-stakes litigation. See Lawrence J. Fox et al., *Report: Ethics Beyond the Rules: Historical Preface*, 67 FORDHAM L. REV. 691, 695 (1998) (“each participant justifies his or her conduct, but savages the conduct of others”). Studies of business organizations reflect many of the same themes of diffused responsibility leading to no one accepting responsibility while attempting to maintain secrecy and then blaming others when secrecy is lost. See, e.g., ROBERT JACKALL, *MORAL MAZES: THE WORLD OF CORPORATE MANAGERS* 17–22 (1988). Other studies reflect a theme found in the POWERS REPORT, *supra* note 16, that the ethical climate of an organization is set by the conduct of those in authority. See DIANE VAUGHAN, *THE CHALLENGER LAUNCH DECISION: RISKY TECHNOLOGY, CULTURE, AND DEVIANCE AT NASA* 405-09 (1996) (concluding that an organizational culture established at high levels, emphasizing production goals, often develops a normative environment that conflicts with that of the outside world, becoming a deviant culture).

137. For discussion of the reasons why lawyers tend to believe they are immune from liability, see Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARVARD J. PUB. POLICY (forthcoming 2002).

which one of their major functions is to determine whether the action meets legal standards. The managers, who hire and fire lawyers, rather than the corporate entity itself, become the client. The *Central Bank* case and the Private Securities Litigation Reform Act also give lawyers a false sense of security by suggesting that they are not accountable for assisting a securities fraud.

Preaching to lawyers and bar groups about their moral and public responsibilities has proven to be ineffective. Professional discipline, for a variety of reasons, provides virtually no control over the failure of law firms to monitor the partners who are bringing in juicy fees from corporate clients.¹³⁸ The spread of limited liability partnerships accentuates the willingness of partners to ignore the risks that other partners are taking. Today's emphasis on "the bottom line" both in corporations and law firms gives rise to a culture valuing the false sense of prestige and status that flows from being among the leaders in the annual listings of profits per partner. From the vantage point of respect for law and the public responsibilities of lawyers, the current scene runs the risk of being "a race to the bottom." As stated above, there is a systemic problem that requires systemic solutions.¹³⁹

The ABA and major state bar organizations speak with divergent voices when engaged in formulating the ethics rules that should govern a lawyer in client fraud situations. Many lawyers, especially business and securities lawyers, argue that a lawyer should be at least permitted to disclose confidential information to prevent or rectify a client fraud. They argue that the professional duty of confidentiality should include the same policy that the law has always applied to the attorney-client privilege: confidentiality evaporates when a client attempts to use the privilege to further a crime or fraud. This balance of confidentiality and the public interest in preventing crimes and frauds has been persuasive to most state courts in promulgating ethics rules.

But the ABA House of Delegates and some major jurisdictions (e.g., California and District of Columbia) have differed, concluding that client candor and adversary representation would suffer if a lawyer were permitted to disclose infor-

138. Discipline of large firm corporate lawyers rarely occurs even in situations in which lawyers have been sanctioned by a court for misconduct or found civilly liable for assisting a client's fraud. As indicated previously, ethics rules applicable in client fraud are controverted, ambiguous, and often discretionary. Moreover, disciplinary authorities lack the resources and the will to charge large law firm lawyers with misconduct in matters that are complex and would require large effort. The occasional efforts to do so are attacked vigorously by the organized bar. For other reasons why professional discipline plays virtually no role in the regulation of lawyers engaged in specialized corporate practice in extensively regulated fields such as securities law, see Ted Schneyer, *From Self-Regulation to Bar Corporatism: What the S&L Crisis Means for the Regulation of Lawyers*, 35 S. TEX. L. REV. 639, 643-50 (1994); see also Koniak & Cramton, *supra* note 137.

139. The blizzard of accounting and related scandals following Enron and Andersen suggests the breadth of the problem: Adelphia, CMS Energy, Dynergy, Merrill Lynch, Tyco, WorldCom, Xerox. "Everybody did this," says economic historian Peter Temin . . . 'The people who got in trouble are those who are most at the edge. Enron didn't get caught. Enron got so far out on the edge that it fell off.' David Wessel, *Venial Sins: Why the Bad Guys of the Boardroom Emerged en Masse*, WALL ST. J., June 20, 2002, at A1. Treasury Secretary O'Neill "recalls a parade of Wall Street professionals who came to his office with plans for 'new and exotic' financial maneuvers to reduce his company's tax bill or report debt levels in ways 'not clearly prohibited by the tax code or law,' but not designed to illuminate corporate operations, either." *Id.* "The remnants of a professional ethos in accounting, law and securities analysis gave way to getting the maximum revenue per partner." *Id.*

mation to prevent or rectify crimes or frauds.¹⁴⁰ These voices oppose attempts to clarify the duties of lawyers who find themselves in client fraud situations. Some of the bar's apologies and evasions are:

- Lawyer liability will grow (why shouldn't lawyers be liable to third persons when they aid or assist a client in defrauding third persons?).
- The rules governing lawyers aren't clear (why should lawyers be entitled to more clarity than is provided to non-lawyers, who must deal all the time with uncertain rules in law, accounting and elsewhere?).
- The lawyer's job is to provide zealous advocacy (they are not acting as courtroom advocates but as office counselors who can assist only lawful transactions).
- "Everybody [is] doing it" (that may well be the case but since when does that excuse wrongdoing?).¹⁴¹

Many informed and able commentators argue that the Enron collapse should not provide the basis for any "reforms" that would affect lawyers and the legal profession. Some tinkering with the accounting rules may be desirable, but in all other respects things are just fine as they are.¹⁴² The savings and loan crisis also led to some cries for reform, but the accounting and legal professions, usually supported by the corporate community, opposed the reforms. The result was legislation designed to deal with too much litigation against corporations and their advisers: enactment of limited-liability partnership statutes in virtually every state, and on the federal level, passage of the 1995 Act and other follow-up securities legislation. Professional advisers were given *more* protection from being accountable for their legal wrongs.

I believe that the following reforms are needed to make lawyers more accountable guardians of the public trust, a goal that depends upon lawyers channeling conduct along lawful paths rather than looking the other way as their clients violate the law. We need more respect for the law on the part of all lawyers, not gradually accelerating disrespect.

CHANGES IN FEDERAL LAW AND REGULATION

When the first draft of this Article was prepared in April 2002, one of its principal recommendations was that legislation should be adopted to give the SEC clear authority to regulate and discipline lawyers who assist clients in securities laws violations. At that time I could not anticipate that such legislation would in fact be enacted. For many years the accounting and legal professions, usually

140. The ABA *Preliminary Report*, *supra* note 7, is a happy exception. The Report treats the current scene as one requiring substantial improvements in the corporate governance process and major changes in the ethics rules governing lawyers.

141. See William H. Simon, *The Kaye Scholer Affair: The Lawyer's Duty of Candor and the Bar's Temptations of Evasion and Apology*, 23 LAW & SOC. INQUIRY 243, 268-74 (1998) (discussing these and other apologies and evasions).

142. See, e.g., Thomas J. Donahue, *Let the Market Do Its Work*, NAT'L L.J., May 6, 2002, at A20; C. Evan Stewart, *Caveat 'Reformers': Lessons Not To Be Learned from Enron's Collapse*, 34 SEC. REG. & L. REP. (BNA) 310 (Feb. 25, 2002).

joined by the business community, have managed to block federal legislation that would provide the SEC with greater authority to regulate accountants and lawyers. The SEC, recognizing that political opposition to such regulation was affecting its staffing and funding, abandoned its earlier efforts to set some minimal standards for lawyers. In view of this background, I believed that a political whirlwind would be necessary to produce legislation explicitly authorizing the SEC to create standards of professional conduct applicable to lawyers engaged in securities law practice.

However unlikely it seemed in April 2002, that whirlwind came about some three months later. The storm aroused by Enron's collapse became a hurricane after the WorldCom bankruptcy and the corporate responsibility scandals at a number of other major companies. The political fallout of the public's concern resulted in the Sarbanes-Oxley Act ("Corporate Reform Act")¹⁴³ which became law on July 30, 2002. The Corporate Reform Act made two major changes in the law governing lawyers. Section 307 of the Act, first, conferred a broad power on the SEC to establish rules of professional conduct for securities lawyers and, second, directed the SEC to issue a specific rule requiring a lawyer for a public company to climb the ladder of authority within the company, to the board of directors, if necessary, "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof . . . if the [chief legal] counsel or [chief executive] officer does not appropriately respond to the evidence [by] adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation."¹⁴⁴

SEC AUTHORITY TO PROMULGATE RULES OF PROFESSIONAL CONDUCT FOR SECURITIES LAWYERS

The initial clause of section 307 gives the SEC 180 days to "issue rules, in the public interest and for the protection of investors, setting forth minimum stan-

143. Pub. L. No. 107-204, 116 Stat. 745 (2002). The legislation was supported by a unanimous vote in the Senate and an overwhelming vote in the House. My discussion of section 307 of the Act has benefited from unpublished letters and e-mails of George Cohen, Richard Painter, and John Steele.

144. § 307, 116 Stat. at 784. Section 307 of the Corporate Reform Act, entitled "Rules of Professional Responsibility for Attorneys," reads as follows:

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

- (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
- (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors . . . or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

dards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of [public companies]"¹⁴⁵ This grant of general rulemaking authority in the professional responsibility area is broad and mandatory. The phrase "minimum standards of professional conduct" characterizes all professional rules of conduct. The only constraints are the limitation to lawyers practicing federal securities law and the requirements that the rules serve the public interest and protect investors.

The provision transfers primary regulatory authority in this area of practice from the state courts that now promulgate the profession's ethics rules to the SEC. Securities lawyers will now be subject to discipline by the SEC for violations of the rules of conduct the Commission adopts. Because no preemptive intent is indicated, securities lawyers will remain subject to state disciplinary proceedings that are not inconsistent with the rules of professional conduct adopted by the SEC. The many questions that will arise concerning the scope of SEC authority, the manner in which the SEC promulgates and enforces the conduct rules, the effect of the new rules on state authority under the Supremacy Clause, and the like are important matters, but they are beyond the scope of this Article.

How should the SEC approach this broad task during the limited time available (i.e., prior to January 26, 2003)? I believe that the SEC would be well-advised to start with a review of the ABA Model Rules of Professional Conduct, as amended in February 2002 in response to the recommendations of the Ethics 2000 Commission. That review should then determine which rules and topics should be made applicable to securities lawyers. The SEC's long experience in enforcing the securities laws in the interest of investors can inform judgments whether a particular aspect of securities law practice should lead to an SEC rule defining minimum professional conduct for securities lawyers. The rules relating to prohibited assistance, the professional duty of confidentiality, conflicts of interest, representing an entity, withdrawal, and probably other subjects should be studied and modified as necessary to meet the special requirements of securities law practice. Rules having to do with subjects that do not directly relate to the special circumstances of securities practice (e.g., rules dealing with the economic regulation of the profession, unauthorized practice, and the provision of information about legal services) should be omitted from consideration.

In several important areas, the SEC should substitute its own judgment and that of the ABA Task Force on Corporate Responsibility for those of the ABA House of Delegates. The Corporate Reform Act requires that it do so with respect to Rule 1.13, representing an entity.¹⁴⁶ With respect to the rules relating to disclosure of confidential information to prevent or rectify a client's prospective or ongoing crime or fraud, the Task Force's recommendations, formed in the light of current problems and informed by broad knowledge of corporate and securities practice, should be substituted for the rules adopted by the House of Delegates in February 2002.

145. *Id.*

146. *See id.*; MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002).

SEC RULE REQUIRING LAWYERS TO CLIMB THE CORPORATE LADDER

In addition to the required general rulemaking with respect to the professional conduct of securities lawyers, the SEC is directed to establish a rule within 180 days that will require securities lawyers to climb the ladder of authority within a public company "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the chief executive officer of the company," and to the board or board committees if those officers do not take "appropriate remedial measures or sanctions."¹⁴⁷

The breadth of the provision is notable: it applies to any "breach of fiduciary duty," issues that generally are viewed as matters of state corporate law unless federal law creates a fiduciary duty. The major qualification is that the violation must be a "material" one. Until the SEC provides more guidance, securities lawyers will have to make difficult judgment calls: When does a lawyer have sufficient "evidence" of a violation? What constitutes a "securities law violation," a "breach of fiduciary duty," or a "similar violation"? When is a violation "material"?¹⁴⁸

The statutorily-prescribed rule clearly draws on the prior actions and decisions of the SEC. In essence, it is a version of the standard that the SEC has been pushing for years: in-house and outside counsel who become aware of facts strongly suggesting that an agent of a corporation is involved in securities fraud *must take steps*, designed to be effective, to ensure that the board understands

147. § 307, 116 Stat. at 784. The prior work and advocacy of two academic lawyers contributed substantially to the enactment of the Corporate Reform Act. Richard Painter initiated the matter by asking the ABA Ethics 2000 Commission to amend Rule 1.13 to require a lawyer to inform senior officers of the corporation of illegal acts for which the corporation could be held responsible. If those officers failed to take appropriate preventive measures, the lawyer should be required to report the matter to the board of directors or to an appropriate organ of the board, for example, the outside directors or the audit committee. See Painter, *supra* note 63, at 10–11 (discussing his proposed amendment to Rule 1.13). In 2001, Painter revised his proposal as an SEC regulation and obtained the support of about forty academic lawyers (including the author). See Letter from Richard W. Painter, College of Law, University of Illinois at Urbana-Champaign, to Harvey Pitt, SEC, Chairman (Mar. 7, 2002) and response letter from David Becker, SEC, General Counsel, to Richard W. Painter, College of Law, University of Illinois at Urbana-Champaign (Mar. 28, 2002) (declining to consider the matter because of the legal profession's heated opposition to it and the SEC's lack of express legislative authority), available at http://www.abanet.org/buslaw/corporateresponsibility/responsibility_relatedmat.html.

Susan Koniak, who testified before a Senate committee considering the role of lawyers in the Enron affair, later worked with Senator Edwards and his staff on the rulemaking proposal that became section 307 of the Senate bill in mid-July. Senator Edwards, with Ms. Koniak's assistance, defended the provision in the Senate and in the conference committee against opposition fueled by the ABA. The provision survived, becoming law on July 30, 2002.

148. The generality of the statutory terms outlining the report requirement can be taken care of by good drafting on the part of the SEC. The major problems are the vagueness of "evidence" of a "material violation" and the absence of an intent standard. The SEC should make it clear that "evidence" does not refer to evidence rules concerning admissibility, but to "facts or circumstances that a lawyer, acting with reasonable care, knows or reasonably should know are credible and substantial evidence of a violation of federal securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" Comments to the text of the report rule should make it clear that a duty of inquiry exists under some circumstances. The ABA *Preliminary Report*, *supra* note 7, at 208 n.49, relying on ABA ethics opinions, provides a useful statement of the facts or circumstances that give rise to a duty to investigate. See *supra* notes 58–59 and accompanying text.

what the lawyer has discovered and must take steps to encourage the board to take action to disclose what it has discovered to the SEC and investing public.¹⁴⁹

Moreover, the new law clearly draws on the ethics rule now in effect in all or virtually all states. Model Rule 1.13 requires a corporate lawyer to act in the best interests of the corporation.¹⁵⁰ Many commentators interpret the rule as requiring a lawyer to climb the ladder of authority in the organization when the lawyer knows that the organization's managers are harming the organization (and third persons) by engaging in criminal or fraudulent conduct. The difference is that the new law clearly requires the lawyer to act in these extreme circumstances, while Rule 1.13 is ambiguous and can be construed as discretionary and permissive. In short, the new law provides clear and helpful guidance to lawyers.

Several objections to the new law should be discussed. First, the ABA and state bar organizations argue that the formulation of rules of professional conduct for lawyers has been and should be carried out by the high courts of the states and not by federal regulation. The exclusion of the legislative process, both state and federal, leaves lawyers and their organizations more in control, resulting in more self-regulation than is given to any other profession. Self-regulation has many advantages, but falls short when the interests of the profession are put above those of the public. On the fundamental question of a lawyer's duty to prevent or rectify criminal or fraudulent conduct by a client or a client's agent, the ABA and a number of state bars have put the interests of the profession above those of the public. Federal legislation and regulation provide the best vehicle for needed change.

Moreover, the dispersion of authority to the high courts of the fifty states and the District of Columbia results in rules that are often conflicting and inevitably different. The ABA makes recommendations that are then filtered through bar groups in each state. The result, at least in every state with a large lawyer population, is a separate set of rules with some common characteristics but differing language. Conflicting requirements and lack of uniformity are especially frequent and most troublesome on the vital subject of a lawyer's obligations in dealing with the prevention and rectification of criminal and fraudulent client conduct, which is precisely the problem that Congress and the public are most concerned about.

The federal government has a strong interest in assuring the integrity of securities markets and the role and conduct of accountants and lawyers are important components. Moreover, there is a long history of federal involvement in specialized areas of law, including patent law, tax law, securities law, and other fields. The further development of distinctive rules of professional conduct in various

149. The court in the *National Student Marketing* case stated that the lawyers had a duty to take steps that would prevent the securities violation, which in that case might require informing shareholders if the officers and directors refused to act. 457 F. Supp. 682, 713 (D.D.C. 1978); see *In re Carter & Johnson*, SEC Release No. 34-17597, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981); *In re Gutfreund*, Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,597 (Dec. 3, 1992).

150. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002).

areas of practice may well be a desirable development in departing from the "one size fits all" approach of state ethics rules. The Commerce Clause clearly supports this federal involvement, which has the great benefit of providing lawyers in those areas of practice with clearer and more uniform standards.

The ABA, in opposing section 307, urged that Congress should allow the process begun by the ABA Task Force to continue. But consider the problems. The Task Force arrived at a "preliminary" recommendation that Model Rule 1.13 be amended by the ABA to require lawyers to report to superior authority within the organization in situations similar to those dealt with in the federal legislation.¹⁵¹ Even if the Task Force persists in the recommendation, it is unclear whether the ABA House of Delegates will adopt the Task Force's sweeping recommendations concerning exceptions to confidentiality (Rules 1.6 and 4.1) and reporting within an organization (Rule 1.13). Similar recommendations were rejected by the House of Delegates during the past year as well as in 1991 and 1983. Even if the ABA adopted the Task Force's proposed amendments, that action would only begin a long and uncertain process in which fifty-one U.S. jurisdictions would consider whether and in what form to adopt the changes. The process would take years and the results would probably be uneven and non-uniform. Federal regulation, on the other hand, will produce a uniform national rule by the end of this year.

Nor does the new "climb the ladder" rule involve a breach of confidentiality (i.e., disclosure not authorized by current ethics rules). The new rule is limited to disclosure within the client organization. The rule merely ensures that the superior officers or board of a public company will learn of information that is of vital importance to the company and be in a position to take corrective action. In short, the new rule overcomes the tendency of lawyers to treat the managers, with whom the lawyer deals day to day, as if they were "the client," rather than to follow the law in treating the corporate entity as the client. In short, the rule protects the interests of the real client.

Another objection is that the new rule will expose lawyers to greater civil liability and that the threat of liability will distort the lawyer-client relationship. Section 307 does not create any new private cause of action against lawyers who participate in corporate fraud. Existing law providing for malpractice liability to a client and, in some situations, liability to non-clients, are unaffected. It is true that any new standard of professional conduct provides an opportunity in a malpractice or third-party liability situation for a showing that a lawyer has departed from customary standards. That would be true of the ABA Task Force recom-

151. The ABA Task Force proposal would require the lawyer to report "that the officer or employee is acting illegally or fraudulently, or in breach of a duty to the corporation . . . [w]hen the lawyer knows or reasonably should know" of such activity. *ABA Preliminary Report*, *supra* note 7, at 204. The federal rule is triggered by the lawyer's possession of credible "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof" Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307(1), 116 Stat. 745, 784. Both rules appear to reach all serious violations of law and the required element of knowledge or intent is similar. The major difference is that the federal rule is applicable only to "public companies" (about 17,000 corporations who are subject to SEC financial disclosure obligations) while the Task Force proposal would reach all entity organizations, public or private, profit or nonprofit.

mendations as well as the new federal rule. But this risk must be weighed against the uncertainties of current law, which lead some lawyers to remain silent while corporate managers commit illegal acts that harm the corporation and third persons. Greater clarity about a lawyer's duties in these troublesome situations may well reduce the frequency of claims rather than increase them, while protecting important interests of the economy and the public. And even if lawyer exposure to liability claims is increased somewhat, the trade-off in prevention of serious frauds on the public justifies that risk.

Whether the new rule will substantially affect the lawyer-client relationship is also highly speculative.¹⁵² Some lawyers worry that corporate lawyers will be too self-protective and, as a result, will prematurely "jump the queue" straight to the board, thus undermining the chief legal officer or manager to whom the lawyer regularly reports. If so, candor and trust between outside counsel and those officers would be adversely affected. It seems more likely, however, that inside and outside counsel will allow the issue to percolate within the corporation in the customary manner until it is properly resolved. The informal norms by which sensitive issues are handled within a corporation are extremely powerful; corporate lawyers will continue to respect them and will not go up the ladder prematurely. The report provision merely gives the outside lawyer some last-resort leverage that may ensure that the problem is properly resolved at an earlier stage without going to the board.

In sum, the new federal rule is a welcome, meaningful, prudent, and timely reform. The bar should embrace it rather than resist it. Thus, I am very pleased that congressional action has deprived me of one of the reform recommendations for federal action that I included in my initial draft. Several other important matters, however, are left untouched by the Corporate Reform Act and I now turn to them.

OTHER DESIRABLE CHANGES IN FEDERAL LAW AND REGULATION¹⁵³

Restore a private right of action for aiding and abetting liability of professionals who assist a client in a securities fraud. The *Central Bank* case should be overruled by legislative action.¹⁵⁴ Congress should restore private causes of action against lawyers and accountants for aiding and abetting federal securities law violations. Since 1994 professional advisers can be held civilly liable for securities fraud only if they are central participants in a client's fraudulent scheme, that is, primary violators. Ethics rules placing limits on what a lawyer may do for a client are phrased in terms of a prohibition of "assisting" fraudulent or illegal conduct and state and federal law routinely provide for civil and criminal liability for someone who assists another in wrongdoing. The absence of civil liability for aiding and abetting the federal securities law puts pressure on courts to stretch the meaning of what

152. I am indebted to John Steele for the ideas in this paragraph.

153. This section draws on conversations with Susan Koniak.

154. See *supra* notes 121–23 and accompanying text.

constitutes a primary violation. The absence of a private cause of action for aiding and abetting securities fraud is an anomaly that should be corrected.

Apply the "recklessness" and "willful blindness" standards to govern intent (scienter) in proceedings against lawyers and accountants under the federal securities laws. Legislation overruling the *Central Bank* case should also provide that a uniform scienter standard of "recklessness" and "willful blindness" applies in all securities actions whether they are civil or criminal, public or private. The standards that govern those who aid and abet a fraud in nearly all other contexts under federal and state law should apply also to lawyers and accountants whether the action is brought by a federal prosecutor, the SEC or by private plaintiffs.

Give the SEC clear authority to regulate and discipline lawyers who assist clients in securities laws violations. Section 307 of the Corporate Reform Act appears to remove the legal cloud that has long surrounded Rule 102(e), promulgated by the SEC to discipline securities lawyers and accountants.¹⁵⁵ Its enactment, by giving the SEC express rulemaking authority to promulgate "minimum standards of professional conduct" for securities lawyers should make it clear that the SEC need not first secure a ruling from a federal district court affirming that the lawyer has violated the securities laws before proceeding against that lawyer via Rule 102(e).¹⁵⁶

Provide the SEC with adequate funding to carry out existing and new responsibilities. The SEC has been under-funded for many years. Salaries of its professionals are much lower than those paid to professionals performing similar work in the private sector. Moreover, SEC professionals have been paid at a lower rate than that provided to federal government professionals who perform similar tasks. Finally, the SEC has been woefully understaffed in relation to current duties and cannot handle new ones without increased funding. The SEC should be provided with sufficient funds for all of its current responsibilities. In addition, funds should be provided to enforce the rules required under the Corporate Reform Act and

155. Rule 102(e) has been upheld as a valid exercise of the SEC's rule-making authority as to accountants, *see, e.g., Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979), but I know of no similarly definitive rulings when it comes to the rule's application to lawyers. Moreover, the fact that prior to the enactment of section 307 it was a rule and not a clear statutory mandate led courts to withhold deference from the SEC's interpretation of the rule and application. *Cf. Checkosky v. SEC (In re Checkosky)*, 23 F.3d 452 (D.C. Cir. 1994); and especially, *Checkosky v. SEC*, 139 F.3d 221, 225 (D.C. Cir. 1998) (criticizing the SEC's straddling of the fence on whether negligence sufficed in a Rule 102(e) proceeding or whether recklessness was the standard for discipline). That matter, too, should be decided. Moreover, some modest discipline, a reprimand but not disbarment or suspension, should be provided on a finding of negligence. By definition negligence is the first step on the road to recklessness and it should be discouraged, at least when it comes to accountants, by the threat of SEC censure or reprimand.

156. *See Ann Maxey, SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies*, 22 DEL. J. CORP. L. 537 (1997) (discussing the SEC's declaration that it would not use Rule 102(e) against lawyers without first seeking a court ruling that the lawyers had violated the securities laws). This declaration was one of many retreats the SEC has had to make over the years from its efforts to see to it that securities lawyers were not recklessly assisting fraud. For a description of some of that history of retreat and how aggressively the bar reacts to any attempt by the SEC to rein in reckless securities lawyers, *see HAZARD, KONIAK & CRAMTON, supra* note 1, at 117-39, 739-43. *See also Susan P. Konik, The Law Between the Bar and the State*, 70 N.C. L. REV. 1389 (1992); Susan P. Konik, *When Courts Refuse To Frame the Law and Others Frame It to Their Will*, 66 S. CAL. L. REV. 1075 (1993).

enough funds to bring enforcement actions against lawyers and accountants who aid and abet securities fraud. The Department of Justice will also need additional funding if the new criminal provisions of the Act are to be anything other than window dressing.

Recent actions at the federal level have alleviated some of these concerns by increasing modestly the staffing and funding of the SEC. The long-term concern is whether political support for the SEC will continue several years from now when public attention will have shifted from issues of corporate responsibility.

CHANGES IN STATE ETHICS RULES

In addition to reforms at the federal level, the high courts of the states need to amend their ethics codes to achieve the following goals: (1) provide nationwide uniformity on the important issue of exceptions to confidentiality, and (2) bring about conformity of state ethics rules with the emerging federal law on a corporate lawyer's duty to report law violations within a client organization.

Adoption by all states of an ethics rule providing an exception to the professional duty of confidentiality to prevent and rectify client fraud. As of 2001, forty-one U.S. jurisdictions permit or require a lawyer to disclose confidential information to prevent a client's proposed or ongoing criminal fraud. Most of these states, however, do not have provisions permitting the rectification of a fraud that involved the use of the lawyer's services. Despite its rejection in August 2001 by the ABA House of Delegates, the Ethics 2000 proposal contains a model that is worthy of adoption in all states. Proposed Model Rule 1.6(b) provides for both prevention and rectification:

- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: . . .
 - (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
 - (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's service¹⁵⁷

The ABA Task Force Preliminary Report "recommends that the House of Delegates reconsider and adopt these Ethics 2000 proposals[.]" quoting the rationale contained in the Ethics 2000 recommendation.¹⁵⁸ When a client seriously abuses the lawyer-client relationship by using the lawyer's services in furtherance of a crime or fraud, a lawyer should be permitted to reveal information to the extent necessary to prevent the client from committing a crime or fraud reasonably certain to result in substantial economic loss. "The client's entitlement [to confidentiality] must be balanced against the prevention of the injury that would

157. Proposed Model Rule 1.6(b), available at <http://www.abanet.org/cpr/e2k-rule16.htm> (last visited Oct. 8, 2002).

158. ABA Preliminary Report, *supra* note 7, at 205.

otherwise be suffered and the interest of the lawyer in being able to prevent the misuse of the lawyer's services."¹⁵⁹

The Task Force, however, goes further than did the Ethics 2000 Commission in recommending that the disclosure under Rule 1.6 be

mandatory, rather than permissive, in order to prevent client conduct known to the lawyer to involve a crime, including violations of federal securities laws and regulations, in furtherance of which the client has used or is using the lawyer's services, and which is reasonably certain to result in substantial injury to the financial interests or property of another.¹⁶⁰

The Preliminary Report also makes desirable recommendations for changes in the text or comments of Rules 1.2 and 4.1, which prohibit active participation in a client's criminal or fraudulent conduct. The Report argues that these provisions are overly restrictive in applying only if the lawyer "knows" that a person associated with an organization is engaging in or intends to engage in criminal or fraudulent conduct. Lawyers are encouraged to avoid knowing by "accepting management's instructions and limiting their advice and/or services to a narrowly defined scope, ignoring the context or implications of the advice they are giving."¹⁶¹ Because some lawyers may "turn[] a blind eye to the natural consequences of what they observe and claim[] that they did not 'know' that the corporate officers they were advising were engaged in misconduct,"¹⁶² Rules 1.2(d) and 4.1 should be amended to provide an intent standard of knows or reasonably should know, which is defined in the Model Rules as denoting "that a lawyer of reasonable prudence and competence would ascertain the matter in question."¹⁶³ This recommendation should be adopted wholly apart from the question of whether disclosure to prevent crime and fraud is permissive or mandatory.

I prefer the stronger position of the ABA Preliminary Report on mandatory disclosure in certain instances,¹⁶⁴ but would be delighted if ABA support for either proposal would lead the ten holdout jurisdictions (including California, Delaware, and District of Columbia) to adopt a crime-fraud exception to confidentiality.¹⁶⁵

159. *Id.*

160. *Id.* at 206.

161. *Id.* at 207.

162. *Id.*

163. *Id.*

164. The text of the ABA Task Force's preliminary recommendation concerning Rule 1.6 reads as follows:

Extend permissible disclosure under Rule 1.6 to reach conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another [as recommended by the Ethics 2000 Commission], and [in addition] require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal securities laws, where such misconduct is known to the lawyer.

Id. at 214.

165. In California, despite many assertions that the duty of confidentiality is "absolute," the law is unclear. In the few states that have followed Rule 1.6 as recommended by the ABA (such as Delaware), a "noisy withdrawal" is permitted when the lawyer has issued an opinion or other document that may be withdrawn, providing a lawyer with an indirect opportunity to disclose confidential information.

The more moderate permissive measure may have a better chance of adoption at the state level.

Keeping a client's secrets is among the most important duties of a lawyer—a sacred trust. But the duty is not and has never been an absolute one. Historically, and in the vast majority of American states, the duty of confidentiality evaporates when a client abuses the attorney-client relationship by using the lawyer's services to further criminal or fraudulent activity. Disclosure to prevent future client fraud on a third person or rectify a past one involving use of the lawyer's services reflects the historic position of the legal profession, the prevailing rule in most states, and properly balances the lawyer's duty to client with responsibilities owed to third persons and the public. The same principle limits the attorney-client privilege, which evaporates when the client is using the lawyer's services to further a crime or fraud. Moreover, it is shamelessly inconsistent for the profession to permit lawyers to disclose information to protect their own financial interests (e.g., collect a fee) while prohibiting them from doing so when clients, abusing the relationship, are defrauding third parties. The growing balkanization of American ethics rules would be stemmed by universal adoption of a single rule on this critical subject, which is vital to public trust in the legal profession's integrity and public responsibility.

Adoption by the states of an ethics rule requiring a lawyer for an organization to inform the organization's highest authority of the organization's pending or ongoing involvement in illegal conduct. As a general matter, the power to direct the management of the business and affairs of a corporation or other organization is vested in the board of directors, who can be held personally liable to the corporation for failing to prevent illegal conduct by the corporation's agents.¹⁶⁶ Given the potential risks to the corporation and to those responsible for its management, a lawyer should inform senior officers of the corporation of illegal acts for which the corporation could be held responsible. If those officers fail to take appropriate preventive measures, the lawyer should report the matter to the board of directors or to an appropriate organ of the board, for example, the outside directors or the audit committee. This course of conduct may be mandated by corporate law and is permissible under Model Rule 1.13. Moreover, as Richard Painter has said, "informing a client about the client's past or future violations of the law goes to the heart of the purpose of legal representation."¹⁶⁷ Consequently, lawyers should be required to climb the corporate ladder to protect the corporation from harm caused by its wrongdoing agents.

Model Rule 1.13, which is generally included in state ethics codes, should be amended in each state to require that a lawyer representing an organization report a prospective or ongoing illegal act that is likely to be committed by the organization or one of its agents to the board of directors or other highest authority authorized to act on behalf of the organization, once the appropriate official within the organization has been informed of the illegal act and has failed to take

166. See, e.g., *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

167. Painter, *supra* note 63, at 10.

preventive measure.¹⁶⁸ Corporations would thus be provided greater protection and corporate directors would be given the information they need to protect themselves from personal liability. The proposed rule would also provide guidance to lawyers as to how, in a difficult situation, to uphold both the law and the entity client's interest.

In revising current Rule 1.13, the ABA and state high courts should give high priority to providing lawyers with language and substance that mirror the requirements the SEC will have in place in January 2003. Lawyers should not be faced with conflicting obligations even though the Supremacy Clause demands that the federal one be respected. Maximum guidance will come from national uniformity.

CONCLUSION

The stunning collapse of Enron, coupled with the large number of accounting irregularities and apparent corporate fraud, have created a climate in which reform and improvement of the law governing corporate lawyers is underway. The ABA Task Force on Corporate Responsibility has issued a preliminary report that recommends promising changes in the rules of professional conduct. And, the Corporate Reform Act of 2002 has changed the landscape by authorizing the SEC to promulgate rules of professional conduct for securities lawyers and directing the SEC to issue a rule requiring securities lawyers to climb the corporate ladder to prevent or rectify a securities law violation by the corporation or a breach of fiduciary duty by a corporate employee. Some other reforms are also needed, especially a statutory overruling of the *Central Bank* decision which eliminated private causes of action for aiding and abetting a securities fraud.

168. See ABA Preliminary Report, *supra* note 7, at 214 (stating the ABA Task Force's recommendations).